BNA Insights

Passthrough Entities

In this article, the first of two on nexus standards for passthrough entities, Lynn A. Gandhi of Honigman Miller Schwartz and Cohn examines a recent Michigan Revenue Administrative Bulletin that provides taxpayers guidance on nexus standards under Michigan's relatively new corporate income tax. She highlights that the state's nexus standard is very aggressive for flow-through entities and their nonresident owners, and is incongruous with current case law. In a second article, Bruce P. Ely and William T. Thistle II of Bradley Arant Boult Cummings LLP will examine several of the more interesting and noteworthy nonresident nexus cases and administrative rulings that have come out in the last three years from other states.

Michigan's Treatment of Flow-Through Entities Under Its New Corporate Income Tax Nexus Standards

BY LYNN A. GANDHI

The Michigan Department of Treasury Jan. 29 issued Revenue Administrative Bulletin (RAB) 2014-5, ''Michigan Corporate Income Tax Nexus Standards,'' to provide taxpayers guidance regarding the nexus standards for the relatively new Michigan Corporate Income Tax (CIT).[1]

The RAB provides interpretation regarding the CIT's nexus standards that were effective Jan. 1, 2012, and thus, appears to be retroactive in effect.[2]

The RAB provides three alternative ways in which a taxpayer has nexus under the CIT.[3] There is:

- a physical presence standard based on physical presence in the state of more than one day[4];
- an economic nexus standard based on active sales solicitation[5] with a Michigan gross receipts requirement of $350,000 or more annually; and
- an ownership interest or beneficial interest standard based on an interest in a flow-through entity doing business in the state.

This article focuses on the ownership interest or beneficial interest standard as it relates to flow-through entities, particularly those with nonresident owners.[6]

The treatment of nonresident owners of flow-through entities doing business in the state was also the subject

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[1] Mich. Comp. Laws Section 206.600 et. seq., also known as Part 2 of the Michigan Income Tax Act, effective Jan. 1, 2012.

[2] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5 at 15 (Jan. 29, 2014). Revenue administrative bulletins are written pronouncements of the department's interpretation of tax laws. They aren't promulgated under the state's Administrative Procedures Act, Mich. Comp. Laws Section 24.201 and, therefore, don't have the force of law. The extent to which the Michigan courts follow the guidance contained in RABs is best summarized by *In re Complaint of Rovas*, 482 Mich. 90, 754 N.W.2d 259 (Mich. 2008), which indicated that RABs are given ''respectful consideration,'' which isn't the equivalent of ''deference.'' 482 Mich. at 108.

[3] Mich. Comp. Laws Section 206.621(1).

[4] Mich. Comp. Laws Section 206.621(1). Note, Michigan interprets ''physical presence'' to extend to corporations incorporated, or entities or persons organized, under the laws of the state. Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5 at 6 (Jan. 29, 2014).

[5] ''Actively solicits'' is defined at Mich. Comp. Laws Section 206.621(2). Further guidance may be found in RAB 2013-9, Corporate Income Tax—''Activity Solicits,'' approved June 5, 2013.

[6] For thorough coverage of state taxation of flow-through entities, see B. Ely, W. Thistle & S. Rhyne, ''State Taxation of Pass-Through Entities,'' 32nd New York University Institute on State and Local Taxation (Dec. 12-13, 2013).

of a recent decision by the Michigan Court of Appeals.[7] In *Aikens v. Dep't of Treasury*, the court allowed Michigan taxpayers to report the gain on the sale of their interest in a flow-through entity as business income, which was apportioned to Michigan based upon the entity's factors. Previously, the department had required all income from the sale of a flow-through entity interest to be reported as income from the sale of an intangible asset, which was allocated 100 percent to the state for all Michigan residents.[8]

Introduction

The CIT is comprised of three separate levies—a corporate income tax, a gross direct premiums tax on insurance companies and a franchise tax on financial institutions. The nexus standards of RAB 2014-5 only apply to corporations and financial institutions,[9] since insurance companies are subject to the gross direct premiums tax on written premiums or property or risk located in Michigan.[10]

A ''corporation'' is defined as ''a person that is required or has elected to file as a C corporation as defined under'' Internal Revenue Code Sections 1361(a)(2) and 7701(a)(3).[11] Thus, only C corporations or those entities electing to be treated as C corporations are directly subject to the CIT.

A flow-through entity (FTE) is defined in the CIT as:

> an entity that for the applicable tax year is treated as a subchapter S corporation under section 1362(a) of the internal revenue code, a general partnership, a trust, a limited partnership, a limited liability partnership, or a limited liability company, that for the tax year isn't taxed as a corporation for federal income tax purposes.[12]

A flow-through entity doesn't include any entities disregarded under Michigan Compiled Laws Section 206.699, which are defined as persons disregarded for federal income tax purposes.[13]

Pursuant to Mich. Comp. Laws Section 206.621(1), an individual or corporation may have nexus with the state if it has ''an ownership interest or a beneficial interest in a flow-through entity, directly, or indirectly through 1 or more other flow-through entities that has substantial nexus in this state.''

This CIT nexus standard, unlike a ''physical'' or ''economic'' presence standard, imposes a broad reach that hasn't previously been imposed by the state and will likely be subject to judicial interpretation, pending further guidance by the department in the form of rules, or by the Legislature, with further statutory provisions.

Ownership Interest or Beneficial Interest

Ownership interests are interpreted by the department to include ownership interests with voting rights or ownership interests that confer comparable rights to voting rights.[14] An ''ownership interest with voting rights'' includes all classes of stock in a corporation entitled to vote that possess the power to elect the membership of the board of directors of the corporation.[15]

''Ownership interests that confer comparable rights to voting rights'' include instruments, contracts, agreements or other authority demonstrating an ownership interest in that entity that confers power in the owner to vote in the selection of the management of that entity.[16] For this purpose, there is no distinction between a general partnership interest and a limited partnership interest. The department has stated that ownership interests will be considered ''as possessing the voting rights accorded to them by statute, organization documents filed with the state, by-laws, certificates, agreements or other authority.''[17]

The RAB states that there is no minimum ownership percentage or degree of control threshold that a taxpayer owner of a flow-through entity must have in order for nexus with Michigan to exist. This statement is facially incongruous with the statement contained in the statute that the flow-through entity itself must have substantial nexus in the state.[18]

The department's interpretation seems to be that once a flow-through entity has substantial nexus in the state, any ownership percentage of degree of control of that entity, absent a de minimis standard, will be sufficient to create nexus for purposes of corporate taxation. There is no direct support cited for this statement in the RAB, and the theory behind that statement appears illogical.

As frequently used in the body of state tax laws in the area of nexus, and as held by the U.S. Supreme Court, ''substantial nexus'' is recognized as something greater than ''nexus.''[19] Even if the flow-through entity has substantial nexus, if the ownership or beneficial interest in the flow-through entity is the grounds upon which nexus is conferred, it would be difficult to substantiate nexus under recognized current U.S. Supreme Court jurisprudence, which has consistently required substantial nexus under the Commerce Clause.[20] Without a percentage or standard of ownership or control, it is difficult to analyze whether the requirements under either the Due Process Clause or Commerce Clause have been met.

The RAB flatly states that a beneficial interest in a flow-through entity exists ''where the taxpayer has a direct or indirect interest in the entity or in any benefits derived from the business activity of the entity distinct

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[7] *Aikens v. Dep't of Treasury*, No. 310528, 2014 BL 24505 (Mich. Ct. App. 1/28/14).

[8] The court of appeals decision may present individual income tax refund opportunities for Michigan residents who sold flow-through entity membership interests where the limited liability company, limited partnership or S corporation owned real estate or other business assets outside of Michigan. The general statute of limitations for Michigan income tax refunds is four years, absent an extension of the statute due to audits or federal adjustments. Mich. Comp. Laws Section 205.27a.

[9] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5 at 3, Jan. 29, 2014.

[10] Mich. Comp. Laws Section 206.635.

[11] Mich. Comp. Laws Section 206.605(1).

[12] Mich. Comp. Laws Section 206.607(2).

[13] Mich. Comp. Laws Section 206.607(2); Mich. Comp. Laws Section 206.699.

[14] Mich. Dept. of Treas., Revenue Administrative Bulletin 2013-1, at 2 (Jan. 7, 2013) (Corporate Income Tax Unitary Business Group Control Test and Relationship Tests).

[15] Id. at 2-3.

[16] Id. at 3.

[17] Id. at 5.

[18] Mich. Comp. Laws Section 206.621(1).

[19] See *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), as well as *Tyler Pipe Indus. Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232 (1987) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[20] Id.

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from any legal ownership or control of the entity.''[21] The RAB provides an example that ''a beneficiary to proceeds or income derived from assets or business activity of a trust or estate in Michigan has nexus with Michigan.''[22] This example however, isn't necessarily informative to an understanding of ''beneficial interest'' beyond a trust or estate context. Indeed, the authority cited by the RAB as definitive of the term ''beneficial interest'' is a Michigan Court of Appeals decision defining that phrase in the context of the Michigan Inheritance Tax Act, and isn't necessarily applicable to state nexus jurisprudence.

The RAB flatly states that a beneficial interest in a flow-through entity exists ''where the taxpayer has a direct or indirect interest in the entity or in any benefits derived from the business activity of the entity distinct from any legal ownership or control of the entity.''

In the case of *Walther Estate v. Mich. Dep't of Treasury*,[23] the Michigan Court of Appeals relied upon Black's Law Dictionary to define the term ''beneficial interest.'' The court was reviewing an appeal by the department from the probate court's determination that the transfer of assets from a trust to a limited partnership, whose partners were all lineal descendants of the decedent, is subject to the preferential inheritance tax treatment.[24] The probate court found the transfer qualified for preferential inheritance tax treatment.

The partnership consisted of three general and eight limited partners, all of whom were lineal descendants, and who received distributions of partnership profits derived from investments at the end of each fiscal year.[25] After the decedent's death, the estate sought a redetermination of the tax due and received a ruling that the transfer of the assets to the partnership was entitled to the preferential treatment afforded by the Inheritance Tax Act for family members and lineal descendants.[26]

The department asserted that as all interests in the assets passed to the partnership, and not to the partners individually, the partnership (which wasn't a family member or a lineal descendant) wasn't entitled to preferential tax treatment. The trust contended that the partnership merely held legal title to the trust assets, while the partners (who were the decedent's lineal descendants) have a beneficial interest in the assets and the partnership is merely a conduit though which the partners receive their benefits.[27]

To determine the applicability of the preference, the court noted the term ''beneficial interest'' was undefined in Michigan, and cited the dictionary definition which refers to a ''[p]rofit, benefit, or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control.''[28] The court also noted that the state has enacted the Uniform Partnership Act.[29] One of that act's official comments stated that ''courts in other jurisdictions have held that a partner has a beneficial interest in partnership property considered as a whole''[30] and that a prior panel of the court of appeals acknowledged that a partner has a beneficial interest in partnership property.[31]

The court concluded that the partners in the partnership each had a proportionate beneficial interest in the trust property that was transferred to the partnership following the decedent's death. As the partners were ''lineal descendants'' as defined in the Inheritance Tax Act, they were entitled to preferential tax treatment. The court indicated that to hold otherwise ''would be to render the statutory language 'a beneficial interest in . . .' nugatory.''[32]

It is this last point for which *Estate of Walther* has been cited by the Michigan courts: ''[T]hat when construing a statute, every word should be given meaning and, as far as possible, no word should be treated as surplusage or rendered nugatory.''[33]

The case has also been cited in a property tax assessment matter before the Michigan Tax Tribunal where a petitioner was challenging whether a conveyance of real property was a ''transfer of ownership'' that would allow local taxing authorities to uncap the property for valuation purposes.[34] The petitioner argued that there was no ''transfer of ownership'' because the transfer of the property occurred between related entities. In challenging that characterization, the department alleged that while it agreed with the position that a partner has a beneficial interest in a partnership's property, it didn't agree that individual partners have a percentage interest in any given partnership asset at any point in time.[35] The tax tribunal found that there had been no ''transfer of ownership''—without the need to address *Estate of Walther*.

The reliance upon *Estate of Walther* is curious; the case only provides a definition of ''beneficial interest'' within the context of the Michigan Inheritance Tax Act. It is also interesting that although the old Uniform Part-

[21] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5, at 8 (Jan. 29, 2014).

[22] Id.

[23] 205 Mich. App. 566 (1994).

[24] Mich. Comp. Laws Section 205.202 provides for preferential tax treatment when persons entitled to a beneficial interest in the property are the grandfather, grandmother, father, mother, husband, wife, child, brother, sister, wife or widow of a son, or the husband of a daughter, or to or for the use of a lineal descendent of the decedent grantor, donor or vendor.

[25] 205 Mich. App. at 568.

[26] Id.

[27] Id. at 569.

[28] Id. at 570.

[29] Mich. Comp. Laws Section 449.1 et. seq.

[30] Official comment to Section 25 of the Uniform Partnership Act, citing *Dreisbach v. Eifler*, 764 S.W.2d 631, 633 (Ky. Ct. App. 1988); *Farmers State Bank & Trust Co. v. Mikesell*, 51 Ohio App.3d 69, 75, 554 N.E.2d 900 (Ohio Ct. App. 1988).

[31] *Stroebel-Polasky Co. v. Slachta*, 106 Mich. App. 538, 543, 308 N.W.2d 273 (Mich. Ct. App. 1981), citing *Goldberg v. Goldberg*, 375 Pa. 78, 83, 99 A.2d 474, 39 A.L.R.2d 1359 (Pa. 1953).

[32] 205 Mich. App. at 570.

[33] *Kopietz v. Vill. of Clarkston*, 1997 WL 33352836 (Mich. App.). This is an unpublished opinion and cannot be relied upon as precedent under Michigan Court Rules.

[34] *K&M LLC v. Bear Creek Twp.*, No. 237863, 2000 WL 546814 (Mich. Tax Trib. 4/400).

[35] Id.

nership Act has been interpreted by the courts of other states to hold that a partner has a beneficial interest in partnership property, that interest is necessarily reliant upon the partner's ownership of the partnership interests, as one can't be a partner without ownership of a partnership interest. The same would hold true for membership interests in a limited liability company. The application beyond interests in an estate or trust isn't clear.

Direct or Indirect Interests

The RAB states that the mere ownership interest or beneficial interest in the flow-through entity is sufficient to create nexus in Michigan if the interest is held directly or indirectly through one or more flow-through entities with substantial nexus in the state.[36] While the term ''indirectly'' isn't defined by statute, the department has published guidance defining indirect ownership as ownership through attribution. In RAB 2013-1,[37] the department stated that an ownership interest is indirect when a person constructively owns such an interest.[38]

In determining constructive ownership, the department will apply I.R.C. Section 1563(c), other than Section 1563(c)(2)(B), to all forms of ownership interests and not just corporate stock.[39] Options to acquire any ownership interest in an entity will be considered as owned by the option holder, and a series of options shall be considered as an option to acquire such interest as well.[40]

RAB 2013-1 provides examples for indirect attribution from partnerships, trusts, estates and limited liabilities companies. In the examples provided, the attribution is based on the percentage of interest held by the partner, beneficiary or member, and is also in proportion to his or her interest in capital or profits, whichever is greater. Thus, indirect ownership requires a measurement of actual ownership of interest(s).

The examples don't address direct or indirect beneficial interests. However, in the operating principles section of RAB 2013-1, the department acknowledges that ownership interests constructively owned by a partnership, estate, trust or limited liability company won't be considered as owned by it for purposes of further attribution to make another the constructive owner of such ownership interests.[41] This doesn't appear to be consistent with the language of RAB 2014-5, which states the intent to establish nexus if a ''taxpayer has an ownership interest or a beneficial interest in a flow-through entity indirectly through 1 or more other flow-through entities.'' Harmonizing these different standards may be challenging, since the same statutory provision is relied upon by the department in both.

It is difficult to determine what degree of beneficial interest the Michigan courts will require to support the imposition of nexus for corporate income tax liability. A beneficial interest in a flow-through entity that has substantial nexus in the state shouldn't automatically create nexus in the holder of that beneficial interest; the nexus must be substantial for a company to be subject to the CIT.

RAB 2014-5 also indicates that nexus will be supported when a taxpayer has an interest in any benefits derived from the business activity of the entity distinct from any legal ownership or control of the entity. This is beyond the beneficial interests of a lineal descendent, and it isn't clear what constitutes ''any benefit.''

Consider this: A large Michigan manufacturer, publicly traded, is formed as a limited liability company. A nonresident taxpayer may own 10 shares in the entity, held in a 401(k) plan. The taxpayer is the nominal owner of the shares. Would a spouse, son or daughter (lineal descendants) have a beneficial interest in such shares under the holding of *Walther*? Clearly, that ownership doesn't confer any measurable level of ownership or control over the LLC, but under the guidance provided by RAB 2014-5, nexus would be established.

Is this beneficial interest truly sufficient under U.S. Supreme Court jurisprudence? Suppose we remove the lineal relationship. Assume the nonresident taxpayer has a mortgage on his primary residence. The dividend income received from the shares contributes to the monthly mortgage payments made by the taxpayer. Does the holder of the mortgage have an interest in any benefit derived from the business activity of the entity that is distinct from any legal ownership or control, resulting in nexus with the state? Is the holder of the mortgage now a Michigan taxpayer?

Application of Pub. L. No. 86-272 To Flow-Through Entities

RAB 2014-5 recognizes the protection afforded by Pub. L. No. 86-272[42] for the imposition of a net income tax if the only activity of the company in the state consists of solicitation of orders for sales of tangible personal property.[43] These protections extend to a flow-through entity if the only activity of the flow-through entity in the state is within the protected activities.[44]

It would follow that if the flow-through entity is protected from an assertion of nexus because of Pub. L. No. 86-272, its income flowing to an owner, member or ''holder of a beneficial interest'' in a flow-through entity would also be protected. However, RAB 2014-5 provides:

> The distributive share [of] income of a corporation that has nexus with Michigan that is attributable to (or derived from) its ownership in a flow-through entity whose activities are otherwise protected by PL 86-272 is not itself protected by PL 86-272 and is not excluded from the corporation's corporate income tax base.[45]

The department's position appears to mix nexus concepts with apportionment concepts. What about a corporation that doesn't have nexus with the state? The flow-through entity wouldn't be included in the corporation's unitary group under the definition of ''unitary

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[36] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5 at 8 (Jan. 29, 2014).
[37] Mich. Dept. of Treas., Revenue Administrative Bulletin 2013-1 (Jan. 7, 2013).
[38] Mich. Dept. of Treas., Revenue Administrative Bulletin 2013-1at 6 (Jan. 7, 2013).
[39] Id. at 4.
[40] Id. at 9.
[41] Id.
[42] 15 U.S.C. Section 381.
[43] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5 at 8 (Jan. 29, 2014).
[44] Id. at 13.
[45] Id.

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group'' contained in the CIT.[46] However, Mich. Comp. Laws Section 206.663 provides an addition to the CIT unitary group definition for apportionment purposes and permits the inclusion of a taxpayer's proportionate share of total sales of a flow-through entity (for both the numerator and denominator) when the flow-through entity is unitary with the taxpayer. This can occur when the taxpayer owns or controls, directly or indirectly, more than 50 percent of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of the flow-through entity, and has business activities or operations that result in a flow of value between the taxpayer and the flow-through entity, or between the flow-through entity and another flow-through entity unitary with the taxpayer, or has business activities or operations that are integrated with, are dependent upon, or contribute to each other.

There appears to be a mingling of apportionment concepts and nexus considerations in the RAB.

Even under the *Finnigan*[47] apportionment methodology adopted by the state at Mich. Comp. Laws Section 206.663(2), the income from a flow-through entity that itself doesn't have nexus with the state wouldn't be included in the corporation's Michigan tax base unless the flow-through entity was a member of the corporation's unitary group. Once again, there appears to be a mingling of apportionment concepts and nexus considerations in the new RAB.

Where does this leave the corporation in our example that doesn't have Michigan nexus, but receives income from a flow-through entity that isn't subject to the CIT, by definition, and whose actions are protected by Pub. L. No. 86-272? RAB 2014-5 states that for nexus purposes, the Pub. L. No. 86-272 protection afforded to the flow-through entity doesn't extend to the distributive share of income received by a taxpayer that itself has nexus with the state.

RAB 2014-5 also states that once nexus is established by a taxpayer during a tax year for CIT purposes, nexus will exist for the entire tax year.[48] For nexus asserted because of an interest in a flow-through entity, the sale or other disposition of that interest during a tax year may only provide a fleeting ''nexus'' moment. It is uncertain how this would be applied from a practical sense, especially for the assertion of nexus on an indirect basis, where there could be multiple tiers of ownership with little oversight from the ultimate holder of the ownership or beneficial interest.

Constitutional Concerns

The RAB's discussion regarding the constitutional standards for determining if nexus is properly imposed focuses primarily on economic nexus cases that have been upheld by other states' courts. The department states that the West Virginia Supreme Court's *Tax Comm'r v. MBNA Am. Bank*[49] ''best summarizes the current state of Commerce Clause jurisprudence with respect to nexus.''[50] Perhaps in West Virginia, but not in Michigan.

Michigan has no case law regarding the current statutory nexus standard based on an interest in a flow-through entity under the CIT, a standard that contains a basis for nexus beyond an economic presence standard. The assertion of nexus solely due to an ownership or beneficial interest, direct or indirect, in a flow-through entity, for which no minimum ownership percentage or degree of control threshold has been set, arguably goes beyond other states' economic presence cases.

As noted in the RAB, ''the CIT does not specify any particular degree or minimum amount of ownership or beneficial interest in the flow-through entity that is required in order to establish nexus for the taxpayer.''[51] The RAB states ''as long as the taxpayer has some direct or indirect (through 1 or more other flow-through entities) ownership or beneficial interest in the flow-through entity the taxpayer has nexus with Michigan.''[52]

To support its statement, the RAB provides the almost obligatory footnote reference to *Int'l Harvester Co. v. Wis. Dep't of Taxation*[53] and *Wisconsin v. J.C. Penney Co.*[54] These are seminal cases from the 1940s regarding a state's power to tax dividends received by nonresident shareholders from corporations doing business in the taxing state.

Both *J.C. Penney* and *International Harvester* address due process considerations that arose from Wisconsin's privilege tax on dividends from income derived from property located and business transacted in the state.[55] The corporate payors were required to deduct the tax from the dividends payable to both resident and nonresident shareholders. In *Wisconsin v. J.C. Penney Co.*, the U.S. Supreme Court sustained the tax due to the existence of the withholding provision, which the court found provided that ''the practical operation of the tax is to impose an additional tax on corporate earnings within Wisconsin, but to postpone the liability for

[46] A ''unitary business group'' is defined in Mich. Comp. Laws Section 206.611(6) as ''a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interest that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the unitary business group, or has business activities or operations that are integrated with, are dependent upon, or contribute to each other.''

[47] *In re Appeal of Finnigan Corp.* (Aug. 25, 1988) Cal. Tax Rptr. (CCH) [1986-1990 Transfer Binder] ¶ 401-653 at 25,241-25,243; opn. on petn. for rehg. (Jan. 24, 1990) Cal. Tax Rptr. (CCH) [1986-1990 Transfer Binder] ¶ 401-797, at 25,755-25,757 (opinions collectively referred to herein as ''*Finnigan*'').

[48] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5, at 15 (Jan. 29, 2014).

[49] 640 S.E.2d 226 (W.Va. 2006).

[50] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5, at 18 (Jan. 29, 2014).

[51] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5, at 19 (Jan. 29, 2014).

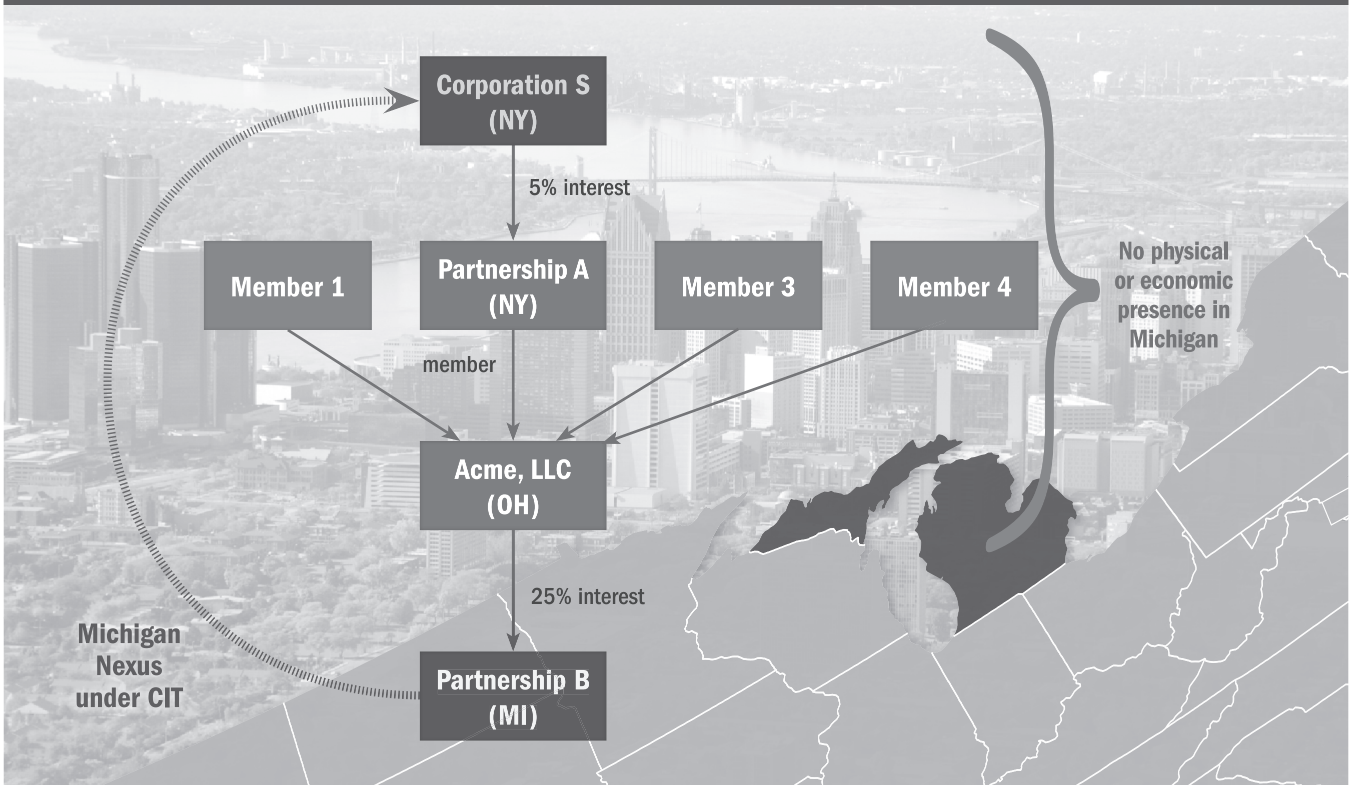
[52] Id.

[53] 322 U.S. 435, 441-443 (1944).

[54] 311 U.S. 435, 444-446 (1940).

[55] 322 U.S. 435, 64 S.Ct. 1060 (1944). The taxing statute under review was Wis. Stat. Section 71.60 (1941).

Creation of Nexus with Michigan for Nonresident Flow-Through Entities



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payment of the tax until such earnings are paid out in dividends.''[56] Subsequently, the Wisconsin courts found that the statute imposed the tax on the shareholders, not the payor.

In *International Harvester*, the Supreme Court revisited the constitutional questions raised under the Due Process Clause.[57] The court found ''Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal residence within the state of the stockholders-taxpayers is not essential.''[58] The court further held, ''A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation.'' Hellerstein & Hellerstein's ''State and Local Taxation'' notes that *International Harvester* relied entirely upon the Due Process Clause and didn't invoke the Commerce Clause.[59]

These cases address a state's right to tax income earned within its borders, and focused solely on due process concerns. Their holdings don't stand for the proposition that, absent a controlling interest of some degree, a mere beneficial interest in a flow-through entity can, in and of itself, create substantial nexus absent further factual review. Michigan exercises these rights, and does tax nonresidents upon income earned within its borders through new withholding requirements for flow-through entities enacted in conjunction with the CIT.[60] These cases stand for the state's ability to tax income of nonresidents, and its ability to impose a withholding liability upon a payor. The department's conclusion appears to go beyond the right to require withholding, though. No further support is cited.

The RAB also provides some examples to highlight activities that will create nexus under the CIT. Examples 12 and 13 are applicable to flow-through entities.

Example 12 states:

> Corporation S, located in New York and with no physical presence in Michigan, has a 5% ownership interest in Partnership A, also located in New York and with no presence in Michigan. Partnership A is a member with 3 other entities in Acme, LLC, located in Ohio with no physical presence in Michigan and that is treated as a partnership for federal income tax purposes. Acme, LLC is a partner with a 25% ownership interest in Partnership B, which is located and conducts business activities in Michigan.[61]

This example is best understood by the accompanying graphic of the discussed structure.

Discussing the example, the RAB concludes that Corporation S has nexus with Michigan due to its indirect ownership interest in Partnership B through the two

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[56] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 61 S.Ct. 246 (1940).

[57] See Hellerstein & Hellerstein, ''State and Local Taxation,'' Eighth Edition (2005), at 944.

[58] Id.

[59] Id. at 945.

[60] Mich. Comp. Laws Section 206.703.

[61] Mich. Dept. of Treas., Revenue Administrative Bulletin 2014-5, at 22 (Jan. 29, 2014).

   ISSN 0092-6884

flow-through entities, Partnership A and Acme LLC (both of which are treated as partnerships for federal income tax purposes, and thus as flow-through entities for CIT purposes).[62]

Interestingly, the RAB's analysis makes no reference to any specific indicia that would indicate the voting power of the ownership interests that are relied upon to substantiate a finding of nexus. There is no discussion of whether the ''instruments, contracts, agreements, or other authority demonstrating an ownership interest in the flow-through entities confers power by the owner to vote in the selection of the management of that entity,'' items that were deemed to be demonstrative of the necessary ownership attributes in RAB 2013-1 regarding sufficient ownership or control for unitary group membership.[63]

Withholding Requirement For Flow-Through Entities

Concurrent with the enactment of the CIT, the state also enacted tough new withholding requirements for flow-through entities operating in Michigan. To ensure compliance with CIT reporting, as well as to minimize perceived tax abuse through the use of flow-through entities, the state implemented new withholding provisions to require withholding by flow-through entities on partners, members or shareholders that are nonresident corporations or other flow-through entities.[64] Note, however, that trusts aren't treated as flow-through entities for withholding purposes, nor is withholding required by publicly traded partnerships.[65]

Withholding is reported on a quarterly basis[66] due April 15, July 15, Oct. 15 and Jan. 15 of the following year. There is also an annual reconciliation report.[67]

Rates and Apportionment

For nonresident individual owners, withholding is required at the full statutory rate for individuals of 4.25 percent, absent consideration of personal exemptions, unless the nonresident individual provides the necessary W-4 information.[68] Withholding is required on a nonresident's distributive share, after allocation or apportionment, which is expected to accrue to the individual. Withholding isn't required on income protected by Pub. L. No. 86-272.

[62] Id.

[63] Mich. Dept. of Treas., Revenue Administrative Bulletin 2013-1, at 3 (Jan. 29, 2014).

[64] Mich. Comp. Laws Section 206.703.

[65] Mich. Comp. Laws Section 206.703(10). ''Publicly-Traded Partnerships'' are defined under I.R.C. Section 7704(b).

[66] Quarterly reporting is done on Form 4917, Flow-Through Withholding Quarterly Tax Return.

[67] Form 4918, Annual Flow-Through Withholding Reconciliation Return, is normally due Feb. 28, or the last day of the second month following the end of the tax year for fiscal year entities.

[68] Mich. Comp. Laws Section 206.703(3). Michigan's individual income tax is a flat rate tax.

Withholding on distributions to corporate owners is required for flow-through entities that expect to have more than $200,000 in annual business income, after allocation or apportionment. This calculation is made at the flow-through entity level, using a 100 percent sales apportionment factor. Once this threshold is met, the flow-through entity must withhold on the distributive share at the full statutory rate for corporations of 6 percent.[69] Withholding is even required from wholly owned flow-through entities.

Withholding on distributions to another flow-through entity is similar to that for corporations.[70] Flow-through entity withholding on intermediate flow-through entities is required to be at the 6 percent rate. However, the individual tax rate may be used if the flow-through entity knows that the ultimate owner of the intermediate flow-through entity is a nonresident individual.

Intermediate flow-through entities will be required to withhold if the source flow-through entity didn't withhold. Thus, the withholding regime is fraught with possibilities for penalties and interest for the failure to properly withhold.

All flow-through entities required to withhold must register with the department.[71] An annual statement must be provided to the members. No specific form is required.[72] Composite reporting is permitted.[73]

Exception From Withholding

An exception from withholding is provided for members of flow-through entities (other than nonresident individuals) by filing an exemption certificate with the flow-through entity. In lieu of withholding, the flow-through entity may be provided a signed Form 4912, Michigan Certification of Exemption for Flow-Through Withholding Payments, by its nonresident member, in which the member opts out of withholding, subjects itself to the jurisdiction of the state and obligates itself to pay the withholding tax on behalf of the flow-through entity.[74]

Conclusion

With the enactment of the CIT, Michigan leads the states with an aggressive nexus standard with respect to flow-through entities and their nonresident owners. This standard is coupled with extensive flow-through entity withholding requirements. Future rules or case law will be necessary to flesh out the incongruity that is apparent in the new guidance provided by the department.

[69] Mich. Comp. Laws Section 206.703(4).

[70] Mich. Comp. Laws Section 206.703(5).

[71] Registration is done by submitting Form 518.

[72] The department suggests use of the member's federal Schedule K-1 to provide such supplemental information. There is no comparable state K-1 form.

[73] Form 807 is used for composite filing.

[74] Mich. Comp. Laws Section 206.703(16).