A Business Perspective

Michigan's New Withholding Requirements for Flow-Through Entities

by June Summers Haas

The business community is still grappling with Michigan's new withholding requirements enacted last fall. While the withholding requirement has been in place for six months, there has been widespread noncompliance and confusion over how to comply. As of October 1, 2003, flow-through entities doing business in Michigan are subject to new withholding and reporting requirements for Michigan individual income tax. A series of six bills enacted in early summer of 2003 imposed the new requirements.[1]

The Michigan Department of Treasury issued Revenue Administrative Bulletin 2003-4, Flow-Through Entity Withholding Tax (RAB 03-04), in December 2003 to provide further explanation of the application of these new laws. This article provides an overview of the new statutory provisions and the department's interpretations. The weaknesses and difficulties created for businesses trying to comply with those requirements are identified. Finally, Michigan's withholding requirements are compared with those of other states and planning opportunities are pointed out.

Who Is Subject to Withholding?

Nonresident members of flow-through entities are subject to withholding of individual income tax. MCL 206.12 defines members of a flow-through entity as a shareholder of an S corporation, a partner of a partnership, or a member of a limited liability company. A nonresident member is defined as an individual not domiciled in Michigan, a nonresident estate or trust, or a flow-through entity with a nonresident member. Technically, flow-through entities are required to get domicile information from their individual members. An individual who temporarily resides in Michigan but is domiciled elsewhere is still subject to withholding. There is no withholding for nonresident corporations or LLCs taxed as corporations. MCL 206.12 specifically excludes publicly traded partnerships formed under Internal Revenue Service Code section 7704 from the definition of flow-through entity. Flow-through entities with flow-through entity members are required to determine whether their member has nonresident members and withhold accordingly.

Basis of Withholding

Income on which withholding is required is not actual distributions to members, but "income available for distribution." Each member's share of income available for distribution is the member's distributive share of the net profits of the flow-through entity that will be included at year-end in the adjusted gross income of the nonmember's federal income tax return and reported on their federal K-1. Withholding must be on profits available for distribution, even if there is no actual distribution made to the partners. In fact, the department has clarified that no withholding is required on actual distributions. Thus, the term "withholding" is really a misnomer because the flow-through entity is not withholding on an actual distribution, but is remitting an estimated tax on potentially taxable income that might not be distributed.

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Equally important is what is not subject to withholding. Withholding is based on net profits; thus, redemptions, returns of investment, and loan repayments are not subject to withholding. Further, net profits available for distribution can be reduced by income excluded from Michigan's income tax such as income from U.S. treasuries or oil and gas production revenues. Moreover, the share of income subject to withholding is only Michigan-source income. Multistate flow-through entities must apportion income to Michigan using the three-factor formula to determine Michigan-source income and then determine the percentage available for distribution to nonresident members based on their percentage ownership in the entity.

In RAB 03-04, the department has provided a number of safe harbors for calculating withholding. Flow-through entities are required to calculate withholding for each quarter, 15 days after the close of the quarter. For most flow-through entities, it is unlikely that accurate income and profit information is

[1] 2003 PA 22, 45, 47, 48, 50, and 51, amending Michigan Income Tax Act, MCL 206.1, *et seq.*

available at that time. There are four methods a flow-though entity may use, other than calculating based on financial information from the current quarter. First, calculations may be based on the first two months of the prior quarter and the last month of the quarter preceding that. Second, calculations may be based on a flow-through entity's profit and loss statements or book income from the current quarter and apportionment factors from the preceding year. Third, calculations may be based on Michigan taxable income from the preceding year. RAB 03-04 does not specify whether it is Michigan taxable income of the flow-through entity or of the members, but as the flow-through entity is not subject to individual income tax, presumably the base is the nonresident member's Michigan taxable income for the preceding year. Fourth, the entity may ask the department for advance permission to use an alternative method that results in a reasonable and accurate estimate of withholding for the year. At this juncture, the department has not approved any alternative calculation methods and has provided no additional guidance on what additional methods may be approved. In all cases, the department has said that apportionment must be based on prior year data or based on a "reasonable estimate" of the factors. There is no guidance on what will be considered reasonable.

Reporting Requirements

There are three separate reporting requirements. First, the entity must report the estimated share of taxable income available for distribution used as the basis for withholding on new form MI-NR K1, "Statement of Michigan Income Tax Withheld for Nonresidents From Flow-Through Entities." Those reports must be sent to each nonresident member no later than January 31 of each year. The business community has already provided feedback to the department that January 31 is simply too soon for most entities to know tentative taxable income. However, the department has given no indication that it will adjust the due dates. Instead, the department has said that amounts need only be estimates. Composite return filers are exempted from this reporting requirement. Second, a duplicate of the MI-NR K1 given to the nonresident member must be filed with the department by no later than February 28 along with Form 165, "Sales, Use and Withholding Taxes Annual Return." Third, the nonresident member is required to provide the flow-through entity with a MI-W4, "Employee's Michigan Withholding Exemption Certificate," containing information on which to base withholding. A nonresident member may claim exemption from withholding on the MI-W4 on the basis that a Michigan tax liability is not expected for the year. That may provide some relief for partnerships when which partners have loss carryforwards.

> Example: Partnership AB has four members, each of whom owns 25 percent of the partnership. Three members are Michigan residents and the fourth is Smith, an Ohio resident. AB is required to get a MI-W4 from the Ohio resident, remit a quarterly withholding to the department, provide Smith with a statement of amounts withheld and the tentative share of taxable distributable income used as a basis for the withholding and provide a copy to the department a month later. The withholding will be a distribution to the Ohio partner that reduces the Ohio partner's distributable share. In light of the partnership's requirement to withhold for the nonresident partner, many partnership agreements may have to be rewritten to provide for equitable distributions of cash proceeds.

Withholding Remittance

Withheld taxes must be calculated and remitted quarterly on the 15th of the month following the quarter's end. Flow-through entities not previously registered for withholding are now required to be registered. If a flow-through entity is already withholding for its employees, the member withholding must be remitted along with and in the same manner as the employee withholding. Thus, entities using electronic funds transfer (EFT) for employee withholding must also electronically transfer member withholding. Flow-through entities may become subject to EFT because of member withholding as well. Flow-through entities that pay an average of $40,000 or more per month in withholding on wages and nonresident member income available for distribution are required to make deposits in the same manner as federal withholding taxes. Thus, withholding must be remitted by EFT as soon as the day after the withholding occurs. Flow-through entity withholding is deemed to occur on the last day of the quarter. Remittance by EFT for accelerated filers must be made at any time after withholding, but no later than the 15th day of the month following the close of the quarter.

Composite Returns

A flow-through entity otherwise subject to withholding for its nonresident members may elect to file a composite Michigan income tax return on behalf of its nonresident members. Revenue Administrative Bulletin 2004-01, Composite Income Tax Return Filing, issued April 5, 2004, provides the department's guidelines for filing composite returns. Flow-through entities filing composite returns are required to remit quarterly withholding on behalf of its nonresident members, beginning with a January 15, 2003, payment for the final quarter of 2002. The quarterly withholding requirements replace the previously required quarterly estimated tax filings required of flow-through entities filing composite returns. Flow-through entities filing composite returns are not required to file annual reports of withholding or income available for distribution to their nonresident members participating in the composite return. Those annual reports must be provided to the department when the composite return is filed. The tax paid through withholding is a credit on the composite return. All composite returns are due April 15 of the year following the entity's tax year-end. The department has issued a revised Michigan Composite Income Tax Return (form 807) and instructions that reflect its new guidance.

Tiered Entities

A flow-through entity that has a flow-through entity as a member is known as a tiered entity. Only a flow-through entity with business activity in Michigan is required to withhold. A flow-through entity with a flow-through entity member that has a nonresident individual owner is required to withhold Michigan income tax without regard to any allowances for personal dependency exceptions, unless the flow-through member provides a MI-W4 for its individual nonresident member and a statement of ownership percentage. The withholding entity reports the amounts withheld directly to the individual nonresident member of its flow-through member. If the flow-through entity member has not provided information about its nonresident individual member or members, then the report of withholding shall be given to the flow-through entity member. Disregarded entities, such as qualified subchapter S subsidiaries or single-member limited liability companies, are deemed to be the same entity as their owner. There is no separate withholding requirement for disregarded entities.

Entities and Income Exempt From Withholding Requirements

Publicly traded partnerships are treated as corporations for federal tax purposes under IRC section 7704 and, as such, are not subject to the flow-through entity withholding requirements. However, publicly traded partnerships not treated as corporations under IRC section 7704(c) are required to file a report of all unit holder information from the federal schedule K-1 of the immediately preceding year on or before August 31. Distributions to exempt entities are exempt from the withholding requirement. Income exempt from withholding includes income exempt from Michigan income tax and the aggregated income available for distribution to all nonresident members if it is less than $1,000 for any quarter.

Penalties

All nonresident members are still required to file nonresident Michigan income tax returns. Failure to do so subjects the nonresident member to failure to file and failure to pay penalties of 5 percent per month of tax due, up to 25 percent under MCL 205.24. Flow-through entities that fail to withhold the income tax of nonresident members are subject to the same penalties as an employer that fails to withhold income tax on behalf of its employees. The flow-through entity may be held liable for the full amount of the tax that was not withheld.[2] Failure to file reports of income and withholding subjects the flow-through entity to a failure to file penalty equal to $10 per day for each separate return not filed, up to a maximum of $400.[3]

Comparison With Other States

More and more states have recently started to require flow-through entities to withhold on nonresident member distributions or distributable income. Currently, 22 states impose withholding on flow-through entities. Three additional states impose a tax on the flow-through entity based on the distributive share of the nonresidents' income. Most of those states that impose withholding on flow-through entities provide for withholding based on the distributable share of income from the state. Only Ohio bases withholding on actual distributions. Eleven states exempt the flow-through entity from the withholding requirement if the nonresident members file consents to the jurisdiction of the state and agree to file income tax returns.[4] An additional five states exempt the flow-through entity from withholding if a composite return is filed by the flow-through entity on behalf of its members.[5] Michigan provides no such exemptions, even for flow-through entities that are filing composite returns for their members. Five states provide for withholding at the applicable tax rate, seven states provide for withholding at a set rate, and 10 states provide for withholding at the highest marginal rate.

Planning Considerations

As more states are now requiring flow-through entities to withhold, flow-through entities may have to amend their operating agreements to comply with those requirements. Flow-through entities may require annual reports of domicile, residency, and submissions of appropriate state W4s. Many flow-through entities will have to amend their operating agreements to provide for compensating distributions to other members when withholding is made and remitted on behalf of nonresident partners. Alternatively, flow-through entities may begin to include new requirements for capital contributions by, or adjustments to the capital accounts of, nonresident partners to fund required withholding. There may be a planning opportunity for entities generating income exempt from Michigan taxation, such as oil and gas production revenues, to establish a special allocation of such Michigan-exempt income to nonresident members. Thus, nonresident partners can claim exemption from withholding on the basis that they will have no Michigan tax liability.

Conclusion

Flow-through entities will have to acquire new information and create new procedures to comply with the new withholding requirements. Many entities will have to amend their organizational agreements to adjust for the new deemed distributions to nonresident members. Compliance with the requirement that a flow-through entity must withhold and remit tax on income available for distribution must be approached carefully. ✰

[2] MCL 206.351(7).

[3] MCL 205.24(5).

[4] Alabama, California, Colorado, Louisiana, Missouri, New Mexico, North Carolina, Ohio, Rhode Island, South Carolina, and West Virginia.

[5] Georgia, Iowa, Kansas, Minnesota, and Missouri.

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