THE NEW MICHIGAN BUSINESS TAX AND ITS EFFECT ON REAL ESTATE COMPANIES

*by June Summers Haas**

On January 1, 2008, a new business tax act (the "Act")[1] became effective in the state of Michigan. This article describes the general structure of the new tax imposed by the Act and highlights some of the effects the tax will have on persons conducting real estate businesses in Michigan. The new concepts and complexities of the Act will be demonstrated through a discussion of the tax impact of purchases and sales of real estate businesses.

General Structure of the MBT

The Michigan Business Tax ("MBT") described in the Act actually consists of five separate tax bases. There are two primary taxes: a modified gross receipts tax ("GRT") imposed at .8% and a business income tax ("BIT") imposed at 4.95%.[2] Most taxpayers will be subject to these two taxes and will have to pay both, not one or the other. There are also two "in lieu" taxes: a gross premiums tax imposed at the rate of 1.25% on insurance companies and a franchise tax imposed at a rate of .235% on financial institutions.[3] Any taxpayer who has to pay one of the in lieu taxes will only pay this tax and will not be required to pay either the GRT or the BIT.[4] Finally, there is a small business credit that effectively works to impose a tax at the rate of 1.8% on the modified federal taxable income of certain small businesses.[5]

Businesses are also subject to a surcharge of 21.99% of the combined GRT and BIT *before credits*.[6] The surcharge was enacted on December 1, 2007 to replace state revenue lost due to repeal of a use tax on services that had originally been scheduled to go into effect on December 1, 2007. The maximum surcharge is $6 million and the surcharge will be repealed as of January 1, 2017 if there is more than zero growth in the consumer price index in any of the prior three years.

Who is Subject to the Tax

Any person with substantial nexus in Michigan is subject to the MBT.[7] The term "person" is all inclusive under the MBT, and includes any partnership, limited liability company, receiver, estate, trust, individual or any other group or combination of groups that act as a unit.[8] Many other states do not impose a business activity tax on partnerships or individuals. Michigan's new business tax scheme is in stark contrast to those other states, and the effect is that some "persons" will pay MBT in Michigan whereas they would not pay a business activity tax elsewhere.

Jurisdiction to Tax

Michigan asserts broad jurisdiction to impose the MBT on any person having a substantial nexus in this state. There are two primary nexus standards under the MBT. First, any person with a physical presence within Michigan for more than one day has nexus.[9] Physical presence means any activity by an employee, agent or independent contractor acting in a representative capacity.[10] Persons engaged in real estate activities in Michigan are generally subject to the MBT based on the in-state location of the real property they own or the activity of managing real property located within Michigan. Second, in one of the more highly controversial concepts in the Act, nexus is deemed to exist in the case of any person who "actively solicits" in Michigan and has more than $350,000 in gross receipts sourced

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to Michigan.[11] Active solicitation has been defined as purposeful solicitation that is directed at or intended to reach persons within Michigan or the Michigan market.[12] One advantage of this low active solicitation standard is that a Michigan business that could not apportion its income under the Michigan single business tax ("SBT"), the MBT's predecessor,[13] may be eligible to apportion sales if the business "actively solicits" customers in other states.[14]

Modified Gross Receipts Tax

The GRT is imposed on the modified gross receipts tax base. Determination of that amount requires a taxpayer to calculate gross receipts by subtracting purchases from other firms, allocating or apportioning the tax base to the State of Michigan, multiplying it by the tax rate of .80%, then subtracting any credits or incentives.[15] MBT's definition of gross receipts is similar to the one in the SBT. "Gross receipts" is defined in the Act as the entire amount received by the taxpayer from any activity[16] unless specifically excluded from that amount.[17] Taxpayers must consider all receipts as gross receipts unless there is a specific exclusion.

The first major exclusion from gross receipts is for amounts received in an agency capacity. This exclusion also existed in the SBT. Cases interpreting the meaning of the term under the SBT should provide guidance as to what constitutes amounts received in an agency capacity under the Act. For instance, in *Stratton-Cheeseman Management Co v Dep't of Treasury*,[18] the Michigan Court of Appeals found that the SBT "clearly excludes from gross receipts the amount received by a taxpayer solely in an agency or representative capacity, while including amounts received as consideration for the performance of personal services."[19] In *Stratton-Cheeseman*, there were two categories of receipts at issue. The first category was insurance premiums and other monies that Stratton-Cheeseman received and deposited into bank accounts designated by an insurance company. The court found that Stratton-Cheeseman was clearly acting as an agent for the insurance company; thus, such monies were excluded from gross receipts. The second category was reimbursement to Stratton-Cheeseman for expenses related to performing management services, including costs of hiring third parties. The court found that these items were includable in gross receipts because the "substance of the reimbursement payments for tax purposes was to compensate plaintiff for services provided in managing the insurance company's business."[20]

Under the Act, real property managers may also exclude from gross receipts the amounts received and placed in a segregated property maintenance account.[21] The value of property received in a like-kind exchange is also excluded from gross receipts.[22] In contrast, the full gross receipts of depreciable property sold is included in gross receipts. If a taxpayer sells any property that is a nondepreciable capital asset under §1221(a) of the federal Internal Revenue Code (the "Code") or land that qualifies as property used in a trade or business as defined under §1231(b) of the Code, only the net gain is included in gross receipts and any return of basis is excluded.[23]

Other relevant exclusions from gross receipts are transfers of accounts receivables; proceeds from the original issue of stock, equity or debt instruments; refunds; discounts (whether they are in cash or in-kind); tax refunds; security deposits; and principal repayments.[24] Proceeds of insurance or civil judgments, unless included in taxable income under the Code, are also excluded from gross receipts.[25]

Once the taxpayer has calculated gross receipts, the taxpayer subtracts out "purchases from other firms" in order to obtain the modified gross receipts tax base upon which tax is calculated.[26] There are essentially three items included in "purchases from other firms."[27] First, there is inventory acquired during the year at cost.[28] This is not a cost of goods sold deduction; it is a calculation of the invoiced cost of inventory acquired during the year. Cost can include shipping, delivery or engineering costs if those amounts are reflected on an invoice. Any separately charged fees for shipping or services cannot be included as a subtractable inventory cost. "Inventory" is specifically defined as the stock of goods that are held for resale, finished goods, goods in process and raw materials of a manufacturing business purchased from another person.[29] Inventory does not include any personal property held for lease, even if such property might otherwise be considered inventory, and does not include any depreciable or depletion property. Second, assets subject to depreciation, amortization or accelerated capital cost recovery for federal income tax purposes may also be subtracted from gross receipts.[30] For a real property business, acquisitions of depreciable real and personal property are excluded from the gross receipts tax base in the year of acquisition.[31] It may be worthwhile for real estate businesses to plan for dispositions and acquisitions of depreciable real property to occur in the same tax year, so that new acquisitions in that tax year will offset gross receipts from a disposition also occurring in that tax year. Third, materials and supplies, including repair parts and fuel, are also "purchases from other firms" that may be subtracted from gross receipts. The Michigan Department of Treasury has interpreted the term "materials and supplies" as limited to items used in and directly connected to inventory or operation or maintenance of assets.[32]

In a special provision, general contractors may deduct from gross receipts the amounts they pay to subcontractors for work on a real estate project under a subcontract specific to that project.[33] Prior to passage of the Act, there was much concern by the general contracting industry that if a gross receipts tax was charged on the portions of general contractors' receipts paid through to subcontractors it would eliminate the economic viability of the general contracting industry. Thus, general contractors were provided a deduction for amounts paid to subcontractors. There are no other deductions for labor costs from the modified gross receipts base.[34]

There is a specific provision in the Act that says that the modified gross receipts tax is not prohibited from being collected by vehicle dealers or boat dealers from their customers, although, of course, the dealers must pay whatever they collect to the Michigan Department of Treasury. This has led other taxpayers to wonder whether they too can collect GRT from their customers and essentially pass on that expense. There is no legislation that prohibits taxpayers from passing on the MBT obligation,[35] and this will likely be a subject of negotiation in business contracts.

Business Income Tax

The BIT is essentially a tax on modified federal taxable income plus adjustments; that amount, times the tax rate of 4.95% and reduced by any credits or tax incentives, is then allocated or apportioned to Michigan.[36] "Business income" is generally defined as federal taxable income.[37] For partnerships and S corporations, business income means income and expenses that are separately reported to partners or shareholders[38] on Schedule K of Form 1065 or Form 1120S.

A taxpayer's BIT base is subject to specific additions and subtractions. The first addition adds back interest and dividends derived from obligations of other states to the extent subtracted in calculating in federal taxable income.[39] The taxpayer must also add back to the BIT base any net income taxes (excluding SBT) that were deducted from federal taxable income, and add back any federal net operating loss.[40] The taxpayer may subtract from business income foreign source dividends including those from a foreign operating entity. The taxpayer may also subtract income from any pass-through entity that is subject to tax or would be subject to tax if it were doing business in Michigan.[41] Essentially, a corporate member of a pass-through entity can exclude the distributive share of income from the pass-through entity. Under the MBT, there is double tax on income from pass-through entities but no triple or quadruple tax.

The MBT contains a provision providing for a related entity expense add-back.[42] The purpose of this provision is to ensure that companies taking deductions for expenses paid to related entities are not engaging in tax planning. Essentially, this provision prohibits deductions made to entities that are not included in the taxpayer's "unitary business group," especially foreign entities. There is an additional subtraction from BIT for any interest from U.S. obligations. Partnerships may deduct any earnings from self-employment under §1402 of the Code except to the extent of earnings that represent a reasonable return on capital.[43] This provision essentially allows owner-operated partnerships to deduct from the tax base amounts paid to partners that are the tax policy equivalent of compensation. Any business loss that is incurred after December 31, 2007 is allowed as a business loss carryforward for ten years.[44]

Filing Threshold and Small Business Credit

To soften the impact on small business, the SBT created a $350,000 filing threshold below which a taxpayer had no obligation to file and no obligation to pay tax. Under the MBT, the filing threshold remains at $350,000.[45] In addition, the Act provides a credit mechanism that has the effect of phasing in the MBT obligation for businesses with less than $700,000 in gross receipts.[46] The MBT small business credit is an expansion of the credit provided in the SBT. Under the MBT, the small business credit works to essentially tax a qualified small business at a rate of 1.8% on modified federal taxable income. In addition, the number of businesses eligible for the small business credit is expanded under the MBT, as businesses with gross receipts of up to $20 million will qualify. Adjusted business income for such businesses may not exceed $1.3 million and owner/operators cannot receive compensation or distributable shares of income in excess of $180,000.

Apportionment

For years under the SBT, Michigan was creeping towards a 100% sales factor. Under the MBT, there is a 100% sales factor, the purpose of which is to shift the tax base as much as possible outside the state. Under the MBT, the tax burden is based on the amount of sales made to customers in Michigan. Hence, businesses that have property and payroll in the state of Michigan do not pay more taxes. Many of the legislators and those designing the MBT were quite straightforward in saying they were looking for ways to make the MBT as appealing as possible for Michigan in-state businesses, and to make sure that out-of-state firms paid as much tax as possible. All taxpayers subject to the GRT and the BIT will apportion their receipts and incomes based on a 100% sales factor.

The MBT also requires that sales in Michigan of any member of a unitary business group be included in the calculation of aggregate sales, even if that member does not otherwise have a nexus in Michigan.[47] The general apportionment rule sources income to the product's destination where the customer receives the benefit of a service.[48] For income from real and personal property, the rules are essentially the same as under the SBT. Income from sales of tangible personal property is sourced to the ultimate destination.[49] Income from the sale, lease, rental or licensing of real property is sourced to the location of the real property.[50] Rental tangible personal property receipts are sourced based on the days in Michigan to the days everywhere, and rental mobile transportation property is sourced based on in-state use.[51]

Financial receipts are sourced, in general, in accordance with financial apportionment sourcing rules that were previously contained in Revenue Administrative Bulletin 2002-14. Royalties and income are sourced to the state where the intangible property was used.[52] Interest from loans secured by real property is sourced to the location of the real property.[53] Interest from loans not secured by real property is sourced to the location of the borrower.[54] Income from sales of services is sourced to where the customer receives the benefit of the services.[55] If the benefit is received in more than one state, then the receipts are included in proportion to the in-state benefit.

There is an alternative apportionment rule under the MBT that allows taxpayers to petition for use of one or more factors.[56] The apportionment provisions under the MBT are presumed to fairly attribute income, and in order to get an alternative apportionment a taxpayer must demonstrate that the business activity attributed to the taxpayer in the state is out of all appropriate proportion to the actual business activity transacted in Michigan, and that it leads to a grossly distorted result.

Unitary Business Mandatory Filing Requirement

The MBT requires mandatory unitary filing, i.e., the filing of a combined return by a unitary business group.[57] The purpose of the mandatory unitary filing is to prevent tax planning and to subject as many companies as possible to the MBT. A unitary group excludes foreign (non-U.S.) companies. A unitary business group is defined as a group of U.S. persons, other than a foreign operating entity,[58] in which one person owns or controls more than 50% of the ownership interest with voting rights or the equivalent of voting rights of the other persons.[59] A unitary business group may include corporations, partnerships and limited liability companies. There must be a flow of value or integration contribution and dependency between or among persons in a unitary group.[60] Unity is a fact-specific determination. In the other 14 states that have adopted the theory of a unitary business group, this is an area of dispute and audit.

For businesses that are part of a unitary group, the unitary group is the taxpayer and files a single return on behalf of all the members of the unitary group. Filing on a unitary basis can be beneficial. Intercompany transactions between members of the unitary group are eliminated for purposes of the calculation of the gross receipts tax base, the BIT base and the sales factor. Losses of one member of the unitary group may offset the income of another.

Credits and Incentives

The SBT had, from its inception, special deductions for capital expenditures and compensation. First, there was a capital acquisition deduction,[61] which was eventually replaced by an investment tax credit.[62] Second, there was an excess compensation deduction, which reduced the SBT of firms that had exceedingly high percentages of their tax bases made up of compensation.[63] Both of these concepts are preserved in the MBT, although in different forms. There is an investment tax credit equal to 2.32% for 2008 and 2.9% for 2009 and thereafter, for new capital additions located in Michigan during a given year.[64] In addition, there is a credit of .296% for 2008 and .37% for 2009 and thereafter, for compensation paid in Michigan.[65] Both of these credits taken together cannot exceed 50% of the tax liability for 2008 and 52% of the tax liability for 2009 and thereafter. The purpose of these credits is to encourage investment in capital and jobs in Michigan.

Many of the economic development incentives under the SBT involved credits that were monetized to help finance real estate projects. Prior to passage of the MBT, there was much concern over whether such SBT credits would be preserved and/or whether it would be possible to carry forward the credits. It was suggested that the failure to permit the credits to be carried forward would have a chilling effect on real estate development. In response to those concerns, specific legislation was passed in 2006 that allowed historic preservation credits and brownfield development credits to be taken as refundable credits in the last year of the SBT. These concerns were baseless because the MBT provides for the transitioning of those economic development incentives from the SBT pretty seamlessly. The MEGA employment credit, the renaissance zone credit, the historic preservation credit and the brownfield credit are all carried forward. A taxpayer that had a credit under the SBT can carry it forward and apply the credit to the taxpayer's MBT liability.[66] Taxpayers should be aware that in addition to extending the ability to carry forward the credits, the recapture provisions in the SBT for some items, such as the MEGA employment credit, will also continue to apply under the MBT.[67]

Probably the most important credit under the MBT, in terms of dollars, will be the tax credit relating to ad valorem taxes on personal property. Starting in 2008, there will be a 24 mill reduction in the industrial personal property millage. There will also be a 12 mill reduction in the commercial personal property millage. In addition, there is a 35% refundable MBT credit for taxes paid on industrial personal property.[68] Consequently, the classification of property as real or personal property has become much more important, and the difference between commercial and industrial within the personal property class is also very important because it affects the amount of tax credit available.

Applying the MBT

The complexity of the MBT and BIT tax bases and the interaction of credits can be seen by looking at the consequences of a typical sale of business assets. Under the MBT, a sale of all the assets of a business, such as a shopping center development, will be subject to BIT based upon the federal taxable income generated by the sale, as modified by the adjustments described in MCL 208.1201. As to the GRT, the modified gross receipts tax base excludes from gross receipts any return of basis on the sale of capital assets as defined under §1221(a) of the Code, as well as land that qualifies as property used in a trade or business under §1231(b) of the Code. In general, the full amount of gross receipts on the sale of all other capital assets will be included in the gross receipts base. Any depreciable, amortizable or assets eligible for accelerated capital cost recovery that are sold will be subject to investment tax credit recapture under MCL 208.1403. For tangible assets purchased before December 31, 2007, the amount of recapture is limited by the amount of investment tax credit utilized by the taxpayer.[69] There is no such limitation on the recapture of tangible assets purchased after December 31, 2007.

The purchaser of business assets is eligible to reduce the gross receipts base by (1) any inventory acquired during the year, (2) depreciable, amortizable or accelerated capital cost recovery assets acquired during the year, and (3) materials and supplies, including repair parts and fuel that are to be used or consumed in and directly connected to the production or management of inventory or the operation or maintenance of assets.[70] The deduction is limited to inventory and assets "acquired during the year." However, the term "acquired" has not yet been clarified. Inventory includes a stock of goods held for resale, finished goods, goods in process and raw material of a manufacturing business purchased from another.[71] Inventory does not include personal property under lease or principally intended for lease, although such leased items may be excludible as a depreciable asset. Capital assets that are excludible as a purchase from another firm include both tangible and intangible assets. Thus, goodwill amortizable under §179 of the Code should be excludible from the gross receipts base as a purchase from another firm.

Purchasers should take care on the timing of business purchases that will result in large exclusions from the modified gross receipts tax base. There is no loss carryforward for any negative modified gross receipts tax base and such a negative base cannot be used to offset any business income tax base. Thus, any deduction below zero of a purchaser's modified gross receipts tax base will generate no tax benefit. Purchasers may want to time the acquisition of business assets to ensure that full benefit of a reduction to the modified gross receipts tax base can be utilized. This may argue against end of the tax year asset acquisitions of businesses. Purchasers may also be eligible to claim an investment tax credit under MCL 208.1403 for any depreciable, amortizable or assets eligible for accelerated capital cost recovery.

Conclusion

The MBT has many new features for businesses to learn and to analyze. Many routine transactions will need to be re-analyzed to determine the effect the MBT will have on them. Each taxpayer should have its accountants or tax professionals run estimates of the cost of the MBT to its business. Each taxpayer should understand which items of income are included in the modified gross receipts base and ensure that its business is structured to eliminate any amounts that can be excluded. Each taxpayer must determine if it is a member of a unitary group and the effect that status as a unitary group has on its filing obligations and MBT liability. There are some limited opportunities to restructure business entities either in or out of a unitary group. Finally, all taxpayers should ensure that they are taking full advantage of available credits and incentives.

Endnotes

1. 2007 PA 36, MCL 208.1101 *et seq.*
2. MCL 208.1201(1); 208.1203(1).
3. MCL 208.1235(2); 208.1263(1).
4. MCL 208.1235(3); 208.1263(2).
5. MCL 208.1417(4).
6. The surcharge may not be offset by the compensation credit or the investment tax credit, which are limited and may only offset tax liability before the surcharge. MCL 208.1403.
7. MCL 208.1200.
8. MCL 208.1113(3).
9. MCL 208.1200(1).
10. MCL 208.1200(3).
11. MCL 208.1200(1).
12. Revenue Administrative Bulletin 2007-6, *Actively Solicits Defined.*
13. 1975 PA 228, MCL 208.1. Repealed by 2006 PA 325 effective December 31, 2007.
14. MCL 208.1301 (providing that a taxpayer may apportion if another state would have jurisdiction to impose a tax of the type provided under the MBT).
15. MCL 208.1203(3); MCL 208.1301.
16. Michigan courts have held that an amount that is not actually received is not included in gross receipts. *See, e.g., Ford Credit Int'l, Inc v Dep't of Treasury*, 270 Mich App 530 (2006).
17. MCL 208.1111(1).
18. 159 Mich App 719; 407 NW 2d 398 (1987).
19. 407 NW2d at 402. *See also PM One Ltd v Dep't of Treasury*, 240 Mich App 255 (2000).
20. 407 NW2d at 401.
21. MCL 208.1111(1)(e) (providing an exclusion for amounts received by a taxpayer that manages real property owned by a third party that are deposited into a separate account kept in the name of that third party and that are not reimbursements to the taxpayer and are not indirect payments for management services that the taxpayer provides to that third party).
22. MCL 208.1111(1)(n).
23. MCL 208.1111(o). This provision may be modified by pending legislation.
24. MCL 208.1111(1)(f)-(g).
25. MCL 208.1111(1)(p).
26. MCL 208.1203(3).
27. MCL 208.1113(6).
28. MCL 208.1111(4).
29. *Id.*
30. MCL 208.1113(6)((b).
31. The cost of an acquisition of a depreciable capital asset should be eligible for the investment tax credit in addition to being a subtraction from the gross receipts base.
32. Michigan Department of Treasury MBT Frequently Asked Question ("FAQ") M4, http://www.michigan.gov/taxes/0,1607,7-238-47449-180195--F,00.html .
33. MCL 208.1113(6)(e).
34. One of the reasons for the lack of labor cost deductions is that is that gross receipts less capital and labor costs results in a value-added tax base. Many of the Michigan legislators did not want to be seen as

having re-enacted any form of value-added tax or a version of the Single Business Tax.

35. The MBT specifically says that the GRT is imposed on a privilege of doing business and not income or property. MCL 208.1203(2).

36. MCL 208.1201.

37. MCL 208.1105(2).

38. *Id.*

39. The question of whether interest from obligations of other states may be taxed while interest from home state obligations is exempt is currently pending before the U.S. Supreme Court in the case of *Kentucky v Davis*, Docket No. 06-666. Until a decision is rendered in that case, Michigan will still tax interest and dividends from other state obligations.

40. MCL 208.1201(2)(b) and (c).

41. MCL 208.1201(2)(e).

42. MCL 208.1201(2)(f).

43. MCL 208.1201(2)(h).

44. MCL 208.1201(5).

45. MCL 208.1505(1).

46. MCL208.1411.

47. MCL 208.1303(2).

48. MCL 208.1305.

49. MCL 208.1305(1)(a).

50. MCL 208.1305(1)(b).

51. MCL 208.1305(1)(c) and (d).

52. MCL 208.1305(1)(e).

53. MCL 208.1305(4).

54. MCL 208.1305(5).

55. MCL 208.1305(2)(c).

56. MCL 208.1309.

57. MCL 208.1511.

58. Under MCL 208.1109(5), a foreign operating entity is a United States person that would otherwise be part of a unitary group; that has substantial operations outside of the U.S., Puerto Rico and any territory of the U.S; at least 80% of whose income is active foreign income under Code Section 861(c)1(b).

59. MCL 208.1117(6).

60. *Id.*

61. MCL 208.23.

62. MCL 208.35a.

63. MCL 208.31(4).

64. MCL 208.1403(3).

65. MCL 208.1403(2).

66. MCL 208.1401; MCL 208.1431-1437.

67. MCL 208.1431.

68. MCL 208.1413.

69. MCL 208.1403(d) - (f).

70. MCL 208.1113(6).

71. MCL 208.1111(4).