

# The New Michigan Business Tax

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# The Presenters

- June Haas, Partner specializing in state and local taxes in Michigan and on multistate basis and former Michigan Commissioner of Revenue.
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# The Michigan Business Tax

What will be covered:

- Who Pays
- Tax Base
- Small Business Rules
- Apportionment
- Unitary Filing

# The Michigan Business Tax

What will be covered:

- Credits and Incentives
- Insurance Company Gross Premiums Tax
- Bank Capital Stock Tax
- Accounting Implications
- Returns, Estimates and Transition Rules
- Potential Litigation and Technical Corrections

# The Michigan Business Tax

- Two Taxes:
  - Modified Gross Receipts Tax
  - Business Income Tax
- Three In Lieu Taxes:
  - Small Business Tax
  - Gross Premiums Tax
  - Bank Capital Tax

# Who is Subject to the Tax?

- All persons with nexus conducting business activity
- Persons is all inclusive:
  - Any corporation, partnership, limited liability company, receiver, estate, trust, individual or any other group or combination of groups acting as a unit

# Nexus

- Any person with physical presence within Michigan for more than one day,  
Or
- That “actively solicits” business in the state and has apportioned gross receipts > \$350,000

# Nexus

- Physical presence means any activity by employee, agent or independent contractor acting in a representative capacity.
- Physical presence excludes activities of professionals or other service providers if activity does not establish and maintain instate market
- PL 86-272 does not apply to gross receipts tax



# Nexus

- “Actively Solicits” must be defined by the Department in writing and be applied prospectively
- How soon will guidance be issued?
- How far will the active solicitation standard go to a pure economic presence standard?

# Modified Gross Receipts Tax

- Modified Gross Receipts Tax
  - Gross Receipts
  - Minus Purchases from Other Firms
  - Allocated or apportioned
  - Times .80%
  - Less credits and incentives

# Gross Receipts

- Gross Receipts

- All amounts received unless specifically excluded

- Exclusions

- Amounts received in an agency capacity
- Amounts received as agent for another and expended on behalf of the agent

# Gross Receipts

## ■ Exclusions

- Income excluded federal tax base of a foreign air carrier
- Advertising agency's cost of media time, space, production or talent
- Real property manager's segregated property maintenance amounts
- Transfers of accounts receivables

# Gross Receipts

- Exclusions

- OID
- Refunds
- Discounts, whether cash or in-kind
- Tax refunds
- Security deposits
- Principal repayments
- Like-Kind exchanges

# Gross Receipts

## ■ Exclusions

- Return of basis on 1221(a) and 1231(b) property
- Insurance or civil judgment unless included in federal taxable income
- Sales finance company repayment of principal

# Gross Receipts

## ■ Exclusions

- Motor vehicle sales finance company principal
- Mortgage company sale of loans
- PEO re-imbusement for wages and benefits
- Motor vehicle floor plan interest credit

# Gross Receipts – Purchases From Other Firms

- Inventory acquired during the year at cost – Not cost of goods sold – including shipping, delivery or engineering costs in invoice
- Assets subject to depreciation, amortization or accelerated cost recovery
- Materials and supplies, including repair parts and fuel



# Gross Receipts – Purchases From Other Firms

- Staffing company compensation of personnel
- General Contractors cost of subcontractors
- No deduction for labor costs

# Gross Receipts - Inventory

- Inventory
  - Stock of goods for resale
  - Finished goods, goods in process, raw materials
  - Motor vehicle floor plan interest
- Does Not Include
  - Personal Property for lease
  - Depreciable or Depletion property

# Modified Gross Receipts Tax

- Imposed on unitary business group's sum of modified gross receipts
  - less foreign operating entity
  - less intercompany transactions
- For 2008 deduct 65% of SBT loss carryforward incurred in 2006 and 2007
- Unitary group SBT loss carryforward only allowed against tax base of company that incurred the loss

# Modified Gross Receipts Tax

- Tax is not prohibited from being collected from customers by vehicle or boat dealers
- Can others collect and pass on the gross receipts tax?
- Gross receipts tax is imposed on privilege of doing business and not on income or property

# Business Income Tax

- Business Income
  - Plus adjustments
  - Allocated or apportioned
  - Times 4.95%
  - Less credits and tax incentives

# Business Income Tax

- Business Income
  - Federal taxable income
  - Partnerships and S Corporation means income and expenses separately reported to partners or shareholders
  - Tax Exempt person means unrelated business taxable income
- Unitary Business Group Income
  - sum of each member's income less intercompany transactions

# Business Income Tax

## ■ Additions

- Other state obligations interest and dividends deducted from FTI
- Other net income taxes deducted from FTI
- Federal NOL

# Business Income Tax

## Subtractions

- Foreign source dividends including foreign operating entities
- Income from pass-through entity subject to tax



# Business Income Tax

- Related Entity Expense
  - If deduct royalty, interest or other expense
  - Paid to a person outside the unitary business group related by Ownership or Control to the taxpayer
  - For use of intangible asset
  - The n expense must be addedback

# Business Income Tax

- Related Entity Expense Addback required unless demonstrate:
  - Nontax business purpose other than avoidance of MBT, and
  - Arm's length pricing and rates under 482 and 1274(d), and
  - One of the three:
    - Pass-through of third party transaction,
    - Results in double taxation, or
    - Unreasonable to add back as determined by Treasurer and agreed to by taxpayer

# Business Income Tax

- Subtractions
  - Interest from US obligations
  - Earnings from self-employment under 1402 except to extent earnings represent reasonable return on capital
- Business loss incurred after 12/31/2007
- Business loss carryforward 10 years

# Small Business Treatment

- Filing threshold remains at \$350,000 gross receipts (partial credit up to \$700,000)
- Small business-low profit credit is expanded
- Unincorporated credit is eliminated

# Small Business Credit Comparison

	SBT	MBT
■ Tax Cap (% of ABI)	2%	1.8%
■ Gross Receipts limit	\$10 M	\$20 M
■ ABI limit	\$475,000	\$1.3 M
■ Officer Income Limit	\$115,000	\$180,000
■ (Adjusted Business Income=Federal taxable income plus compensation and directors fees of active shareholders and officers, plus loss carry-forwards/backwards)		

# Exempt Entities

- Entities exempt from both modified gross receipts tax and business income tax are unchanged from the SBT
  - US government, this state, other states and their political subdivision
  - Tax exempts and 501(c)(12) and (16)
  - Certain 501(c)(4)s
  - Nonprofit housing corporation
  - Production of agricultural goods
  - Farmer's cooperative
  - Reciprocal insurer's attorney-in-fact
  - Multiple employer welfare arrangement

# Apportionment

- 100% Sales Factor
- Apportioned if taxed in another state or would be taxable in another state is state imposed tax similar to Michigan
- No separate apportionment formulas

# Apportionment

- Finnegan Rule -- Sales of unitary business group is all sales in Michigan regardless of whether the person has nexus with Michigan. Intercompany sales are eliminated.



# Apportionment

- General apportionment rule is destination or where the customer receives the benefit
- Rules are NOT the same as under SBT
- Cost of Performance Test for Intangibles and Services is Gone

# Apportionment – Real and Personal Property

- Sales of tangible personal property sourced to destination
- Rental real property sourced to property location
- Rental tangible property receipts sourced based on days instate to everywhere
- Rental mobile transportation property receipts based on instate use

# Apportionment – Financial Receipts

- In general, law codifies Michigan's version of the MTC's financial apportionment sourcing rules previously contained in RAB 2002-14
- Royalties and income from using intangibles sourced to state of property use
- Interest from loans secured by real property looks to location of real property

# Apportionment – Financial Receipts

- Interest from loans not secured by real property looks to location of the borrower
- Transportation company services sourced based on revenue miles instate to everywhere
- Spun-off company provisions maintained

# Apportionment

- Alternative Apportionment Rule
- May petition for
  - Separate accounting
  - Inclusion of 1 or more factors
  - Other method
- Apportionment provisions presumed to fairly attribute
- Must show business activity attributed to state is all out of appropriate proportion and leads to a grossly distorted results

# Apportionment

- Sales of services sourced to where customer receives the benefit of the services. If more than one state, then receipts included in proportion to instate benefit.
  - No definition yet of “where customer receives benefit”
  - Language based on Ohio but unclear if Michigan will follow Ohio’s many regulations or provide separate rules

# Mandatory Unitary Filing

- Purpose of mandatory unitary filing is to prevent tax planning and subject as many companies as possible to the new tax
- Revenue estimates attributed no new income to move from elective consolidation to mandatory unitary filing
- Water's edge

# Unitary Business Group

- US persons, other than foreign operating entity
- 1 of which
- Owns or controls >50% ownership interest with voting rights
- And flow of value or contribution and dependency between or among the persons in the unitary business group



# 80/20 Companies

- Foreign Operating Entity
- Would otherwise be part of unitary group – US person
- Substantial operations outside US, Puerto Rico and any territory of US
- At least 80% of income is active foreign income under 861(c)(1)(B)

# Unitary Business Filing Implications

- Foreign entities with nexus file on a stand- alone basis
- No special rules for non-PE foreign companies under the gross receipts tax
- Foreign dividends eliminated

# Unitary Business Filing Implications

- Intercompany transactions eliminated
- Deductions denied to nonunitary affiliates
- Finnegan taxes the non-nexus members of the group

# Compensation Deduction and Investment Tax Credit

- Investment Tax Credit: 2.9% of net new capital assets in Michigan
- Compensation Credit: 0.37% of compensation paid in Michigan
- These credits are taken first and together are capped at 65% of tax liability

# Economic Development Credits Retained

- Michigan Economic Growth Authority (Section 431/SBT MCL 208.37c)
- Renaissance Zones (Section 433/SBT MCL 208.39b)
- Historic preservation (Section 435/SBT MCL 208.39c)
- Brownfield development (Section 437/SBT MCL 208.38g)

# Retained Credits (cont.)

- Venture Capital investment (Section 419/SBT MCL 208.37e)
- Charitable contributions (Section 421/SBT MCL 208.38)
- Start-up business (Section 415/SBT MCL 208.31)
- Homeless shelters/Food Banks (Section 427/SBT MCL 208.38f)

# Retained Credits (cont.)

- Alternative energy (Section 429/SBT MCL 208.39e)
- Worker's compensation (Section 423/SBT MCL 208.38b)
- Community foundations (Section 425/SBT MCL 208.38c) - Now includes educational foundations
- Low-grade hematite (Section 439/SBT MCL 208.39d)

To the extent provided by the SBT, existing credits under these sections may be carried forward against the new tax, but recapture provisions also apply.

# Terminated Tax Credits

- Unincorporated Business Credit (MCL 208.37)
- MEGA Business Activity Credit (MCL 208.37d)
- Transferred Jobs Credit (MCL 208.35i and MCL 208.35j)
- Minority Venture Capital Company Credit (MCL 208.36b)
- High Technology Activity Credit (MCL 208.37b) - no new certificates were issued after 1991
- Created Jobs Credit (MCL 208.37f) - only applied to the 2005 tax year



# Terminated Tax Credits (cont.)

- Donated Automobile Credit (MCL 208.37g)
- Apprenticeship Credit (MCL 208.38e)
- Pharmaceutical Research Credit (MCL 208.39f)
- Enterprise Zone Credit (MCL 208.37a)
- These credits may be carried forward for the 2008 and 2009 tax years (to the extent the credit could be carried forward under the SBT)

# New Credits

- Research and Development Credit
  - 1.9% of R&D expenditures
  - 30% of contributions to small business for R&D, capped at \$300,000
- Entrepreneurial Credit (2008-2010)
  - If:
    - gross receipts < \$25 million
    - created 20 new jobs in MI
    - \$1.25 million in capex

Credit equals marginal tax resulting from added employment.

# Special Sector and Arts Credits

- Motor Sports Complex Credit
- Sports/Entertainment Facility
- Motor Vehicle Dealer
- Special Compensation Credit for large retail establishments
  
- Culture Credit: 50% of contribution over \$50,000 to municipal or non-profit art, historical or zoological inst.

# Personal Property Tax Relief

Starting in 2008:

- 24 mill Reduction for Industrial personal property (includes property under IFT)
- 12 mill reduction for Commercial personal property
- 35% refundable MBT credit for taxes paid on Industrial Personal property (replaces 15% credit in SBT)
- 23% refundable MBT credit utility property taxes paid by telephone companies (13.5% in subsequent years)
- 10% refundable credit for personal property taxes on natural gas pipelines.

# Personal Property Tax Relief Example

	<u>Industrial</u>	<u>Commercial</u>
Assessed Value (50% of Market)	\$100,000	\$100,000
Current Average Tax Rate	52 mills	52 mills
Tax under old system	\$5,200	\$5,200
New Tax Rate	28 mills	40 mills
New Tax	\$2,800	\$4,000
MBT Credit Amount	\$980	\$0
Effective Tax	\$1,820	\$4,000
Effective Tax Cut	\$3,380 (65%)	\$1,200 (23%)

# Personal Property Relief

- Classification of property as real or personal becomes more important
- Classification of personal property as “industrial” is usually tied to the classification of the real property where the personal property is located
- Wrong classification must be addressed early in the process

# Insurance Company Gross Premiums Tax

- Gross premiums tax at 1.25% rather than 1.07% under SBT
- Retaliatory tax applicable
- Retains industry specific credits
- Exempt first \$190 disability insurance premiums

# Insurance Company Gross Premiums Tax

- In lieu of all other taxes except real and personal property tax, sales tax and use tax
- Compensation credit and investment tax credit are denied



# Bank Capital Stock Tax

- Tax on average net capital over last five years times .235%
- In lieu of modified gross receipts and business income tax
- Net capital = equity capital under GAAP less cost of goodwill and US and MI obligations
- Tax base is apportioned based on gross business
- Gross business same as under SBT

# Return Filing and Transition Rules

- Effective 1/1/2008
- Fiscal year taxpayers use short year or months in year/12
- Estimated returns due 4/15 while annuals due 4/30

# Return Filing and Transition Rules

- No penalty transition rule
- Revenue Act controls administration by Department of Treasury
- Bill appropriates \$1 million to Treasury for implementation

# Refund Provision

- If net cash revenues exceed
  - Revenue estimate plus 1% and
  - Amount is more than \$5,000,000
- Then 50% of excess refunded to taxpayers making net cash payments
- Net cash is annual and estimated payments during fiscal year less refunds

# Litigation

- Credits
- Denial of credits
- Personal property tax classification
- Refund mechanism
- Finnegan
- Definition of Unitary Business
- Taxation of other states interest and dividend payments

# Possible Areas for Technical Corrections

- FAS 109 requirement to book deferred income tax liability
- Assignability of brownfield credits
- Reporting/payment dates
- Gross receipts tax base
- Treatment of foreign taxpayers
- Finnegan/Joyce

This presentation is intended to provide general information regarding the Michigan Business Tax. It is not intended to be an all encompassing treatment of the subject matter and does not purport to offer legal advice.

# Questions?

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