MILLER CANFIELD
MILLER, CANFIELD, PADDOCK AND STONE, P.L.C.

Michigan

Florida

New York

Canada

Poland

The New Michigan Business Tax

A summary of the provisions concerning the unitary approach, nexus and apportionment

Enrolled Senate Bill 94 of 2007 was signed by the governor July 12, 2007 and has been assigned Public Act number 36 of 2007. Previous alerts have provided a brief description of the new tax package. This article examines those provisions of the new Michigan Business Tax Act concerning the unitary business approach, the definition of the taxpayer, nexus and apportionment.

1. The New Michigan Business Tax Applies the Unitary Business Enterprise Rule to define the term Taxpayer

The new Michigan Business Tax Act applies the unitary business enterprise concept and it does so broadly. This is a significant change from section 77 of the Single Business Tax (MCL 208.77), in which the provisions concerning combined or consolidated filing did not apply the unitary principle as broadly as they could have been applied. Some court decisions even overstated that position by stating that the unitary principle does not apply in Michigan.

The reason for the change in policy from not combining the unitary business enterprises to the present policy of requiring combination of unitary enterprises was stated in the Senate Fiscal Agency's Bill Analysis as follows:

Unitary Filing. Unitary business groups would be required to file a combined tax return. A unitary business group includes a group of businesses that is controlled by one of the businesses and that has activity or operations that flow between the businesses. The goal of unitary filing is to reduce tax avoidance by eliminating the effectiveness of transferring financial transactions among the businesses.

The unitary business group is referenced throughout the Act beginning with the definition of the MBT taxpayer:

Sec 117 (5) "Taxpayer" means a person or a unitary business group liable for a tax, interest, or penalty under this act.

The definition of a unitary business group is broad, including not only the concepts of common ownership, integration of activities, and inter-dependency but a flow of values test based on an undefined facts and circumstances test.

Sec 117 (6) "Unitary business group" means a group of United States persons, 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 interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.

The Act does limit the definition of the unit to entities operating in the United States. It does not use water's edge election, but rather defines the unitary group as excluding certain "foreign operating entities," which are defined as follows:

Sec. 109 (5) "Foreign operating entity" means a United States person that satisfies each of the following:

(a) Would otherwise be a part of a unitary business group that has at least 1 person included in the unitary business group that is taxable in this state.

(b) Has substantial operations outside the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or a political subdivision of any of the foregoing.

(c) At least 80% of its income is active foreign business income as defined in section 861(c)(1)(B) of the internal revenue code.

While financial institutions and insurance companies are defined as includable in a unitary business group, they are effectively then removed from the required combined return in section 511 which requires unitary business groups to file consolidated returns. That section provides:

Sec. 511. A unitary business group shall file a combined return that includes each United States person, other than a foreign operating entity, that is included in the unitary business group. Each United States person included in a unitary business group or included in a combined return shall be treated as a single person and all transactions between those persons included in the unitary business group shall be eliminated from the business income tax base, modified gross receipts tax base, and the apportionment formula under this act. If a United States person included in a unitary business group or included in a combined return is subject to the tax under chapter 2A or 2B, [insurance companies and financial institutions] any business income attributable to that person shall be eliminated from the business income tax base, any modified gross receipts attributable to that person shall be eliminated from the modified gross receipts tax base, and any sales attributable to that person shall be eliminated from the apportionment formula under this act.

Insurance companies and financial institutions are treated separately[1] and their income and receipts are, therefore, adjusted out of the unitary business group's tax base and apportionment formula.

Addressing the use of passive investment holding companies and similar tax planning tools by which companies in higher tax states pay deductible royalties thus lowering their tax in the higher tax rate state to, related entities in low or no tax state which hold the patents or trademarks, the new Act provides:

Sec. 201 (2)(f) Except as otherwise provided under this subdivision, to the extent deducted in arriving at federal taxable income, add any royalty, interest, or other expense paid to a person related to the taxpayer by ownership or control for the use of an intangible asset if the person is not included in the taxpayer's unitary business group. The addition of any royalty, interest, or other expense described under this subdivision is not required to be added if the taxpayer can demonstrate that the transaction has a nontax business purpose other than avoidance of this tax, is conducted with arm's-length pricing and rates and terms as applied in accordance with sections 482 and 1274(d) of the internal revenue code, and satisfies 1 of the following:

(*i*) Is a pass through of another transaction between a third party and the related person with comparable rates and terms.

(*ii*) Results in double taxation. For purposes of this subparagraph, double taxation exists if the transaction is subject to tax in another jurisdiction.

(*iii*) Is unreasonable as determined by the treasurer, and the taxpayer agrees that the addition would be unreasonable based on the taxpayer's facts and circumstances.

Sec. 201 (3) For purposes of subsection (2), the business income of a unitary business group is the sum of the business income of each person, other than a foreign operating entity or a person subject to the tax imposed under chapter 2A or 2B, included in the unitary business group less any items of income and related deductions arising from transactions including dividends between persons included in the unitary business group.

2. The Nexus Standard Casts a Broad Net

While Michigan continues to apply a physical presence test it now requires only one day of in state activity to establish nexus:

[1] The Act imposes a tax on insurance companies of 1.25% of gross direct premiums on property or risk located or residing in the state, but not including premiums on policies not taken, returned premiums on cancelled policies, receipts from the sale of annuities, and receipts from reinsurance premiums if the tax has been paid on the original premium. The bill would exempt the first $190 million of disability insurance premiums written in the state, other than credit insurance and disability income insurance premiums. The exemption would be reduced by $2 for each $1 by which gross direct premiums from insurance carrier services within the state and outside of the state exceed $280 million. There are a series of credits and the tax is in lieu of most other taxes. The Act subjects financial institutions to a separate tax of 0.235% on the average net capital over the last five years. The tax is in lieu of the business income and the modified gross receipts tax imposed on other taxpayers. Net capital would be an institution's equity capital, less the cost of goodwill and U.S. and Michigan obligations. For multi-state institutions, the tax base would be apportioned based on the gross business.

Sec. 200. (1) Except as otherwise provided in this act or under subsection (2), a taxpayer has substantial nexus in this state and is subject to the tax imposed under this act if the taxpayer has a physical presence in this state for a period of more than 1 day during the tax year or if the taxpayer actively solicits sales in this state and has gross receipts of $350,000.00 or more sourced to this state.

(2) For purposes of this section, "actively solicits" shall be defined by the department through written guidance that shall be applied prospectively.

(3) As used in this section, "physical presence" means any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent or independent contractor acting in a representative capacity. Physical presence does not include the activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in this state.

As it must, the new Act acknowledges the limitation of PL 86-272 to the income component of the tax. See section 201 quoted below.

Having defined the term “taxpayer” to include not only individual business entities, but also groups of individual entities, the new and broader nexus test applies to an entire unitary business group. Thus, if any member of the group has by its own action, or those of agents acting for it, establishes nexus, the entire group has nexus.

3. The New Act Imposes Two Taxes -- a Modified Gross Receipts Tax and an Income Tax

The new Act imposes two taxes. A taxpayer pays both of the taxes. A unitary business group computes its tax base for the entire unit.

The imposition section of the Modified Gross Receipts Tax provides:

Sec. 203. (1) Except as otherwise provided in this act, there is levied and imposed a modified gross receipts tax on every taxpayer with nexus as determined under section 200. The modified gross receipts tax is imposed on the modified gross receipts tax base, after allocation or apportionment to this state at a rate of 0.80%.

(2) The tax levied and imposed under this section is upon the privilege of doing business and not upon income or property.

(3) The modified gross receipts tax base means a taxpayer's gross receipts less purchases from other firms before apportionment under this act[2]. The modified gross receipts of a unitary business group is the sum of modified gross receipts of each person, other than a foreign operating entity or a person subject to the tax imposed under chapter 2A or 2B, included in the unitary business group less any modified gross receipts arising from transactions between persons included in the unitary business group.

Consistent with the application of the unitary theory inter taxpayer transactions are eliminated.

[2] While a detailed description of the modifications of the gross receipts is beyond the scope of this article, Section 113 defines “purchased from other firms” to mean (1) inventory, including delivery charges; (2) depreciable assets, including installation costs; (3) other materials and supplies, including repair parts and fuel; (4) and, for staffing companies, compensation of personnel supplied to their customers.

The imposition section of the Income Tax provides:

Sec. 201. (1) Except as otherwise provided in this act, there is levied and imposed a business income tax on every taxpayer with business activity within this state unless prohibited by 15 USC 381 to 384. The business income tax is imposed on the business income tax base, after allocation or apportionment to this state, at the rate of 4.95%.

The precise computation of the base is beyond this article. The Act recognizes the limitation of PL 86-272 on the income tax. PL 86-272 prohibits the imposition of taxes based on net income when the only activity in the state is solicitation for the sale of tangible personal property. Thus, it is possible that a taxpayer having only solicitation activities in Michigan will pay the modified gross receipts tax and not the income tax. The Income Tax computation also eliminates certain inter-taxpayer transactions.

4. The New Michigan Business Tax Applies a Singe Factor Apportionment Formula, based on Sales, to Apportion Both the Income and Gross Receipts Taxes

The apportionment provisions of the new Act adopt a single factor formula for apportionment of the tax base of both taxes assuming that the taxpayer establishes a right to apportion by being taxable in a state outside of Michigan.

301. (1) Except as otherwise provided in this act, each tax base established under this act shall be apportioned in accordance with this chapter.

(2) Each tax base of a taxpayer whose business activities are confined solely to this state shall be allocated to this state. Each tax base of a taxpayer whose business activities are subject to tax both within and outside of this state shall be apportioned to this state by multiplying each tax base by the sales factor calculated under section 303.

To apportion one must be subject to tax in more than one state:

(3) A taxpayer whose business activities are subject to tax both within and outside of this state is subject to tax in another state in either of the following circumstances:

(a) The taxpayer is subject to a business privilege tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax or a tax of the type imposed under this act in that state.

(b) That state has jurisdiction to subject the taxpayer to 1 or more of the taxes listed in subdivision (a) regardless of whether that state does or does not subject the taxpayer to that tax.

The provision of section 301(3)(b), quoted above leaves room for dispute concerning the nexus standard by which other states could impose a tax.

The Sales factor itself is drafted to recognize the application of the unitary business enterprise theory.

Sec. 303. (1) Except as otherwise provided in subsection (2) and section 311, the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax year and the denominator of which is the total sales of the taxpayer everywhere during the tax year.

(2) Except as otherwise provided under this subsection, for a taxpayer that is a unitary business group, sales include sales in this state of every person included in the unitary business group without

regard to whether the person has nexus in this state. Sales between persons included in a unitary business group must be eliminated in calculating the sales factor.

5. In applying the sales factor, Michigan has adopted the so called Finnigan Rule

In computing a sales factor for apportioning the tax base of a unitary group there are at least two approaches. One approach continues to recognize the separate nature of individual members of a unitary group and does not count in-state sales from members which would have no nexus with the state if considered separately. This has been called the *Joyce* rule after a 1966 California decision. Another approach is to consider the unitary group as one entity for purposes of determining nexus and the sales factor. This has come to be called the *Finnigan* rule, again after a California decision.

Appeal of Joyce, Cal Bd of Equalization 11-23-1966 (Docket No 66-SBE-069), was decided in 1966. In computing the sales factor for a unitary group filing a combined return, the numerator includes only the sales from members of the unit which would have nexus with the state if considered separately. States applying the *Joyce* test include: Illinois, Nebraska, New Hampshire and North Dakota.

Appeal of Finnigan, Cal Bd of Equalization 1-24-1990 (Docket No 88-SBE-022), was decided in 1990. In computing the sales factor for a unitary group filing a combined return, the numerator includes all sales from all members of the unit destined for the state, whether or not the members of the group would have nexus if considered individually. States applying the Finnigan rule include: Arizona, California, Kansas and now Michigan.

The new Michigan Business Tax Act adopts the Finnigan approach in its definition of "taxpayer" and the provision for computing the sales factor by providing:

(2) Except as otherwise provided under this subsection, for a taxpayer that is a unitary business group, sales include sales in this state of every person included in the unitary business group without regard to whether the person has nexus in this state. Sales between persons included in a unitary business group must be eliminated in calculating the sales factor.

6. Identifying Sales as Michigan Sales to be Included in the Numerator

The sales factor identifies sales as Michigan sales and thus included in the numerator based on different rules for different types of sales:

- Receipts from sales of tangible personal property use the destination state rule. Sec. 305 (1)(a).
- Receipts from sales or leases of real property are identified with the state in which the property is located. Sec. 305 (1)(b)
- Receipts from leases of tangible personal property are identified with this state to the extent used in this state based on number of days in state divided by days out of state factor. If the physical location of the property during the lease or rental period is unknown or cannot be determined, the

tangible personal property is utilized in the state in which the property was located at the time the lease or rental payor obtained possession, Sec. 305(1)(c)

- Receipts from the lease or rental of mobile transportation property owned by the taxpayer are in this state to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state is apportioned. Sec. 305 (1)(d)
- Receipts from the use of intangible property such as royalties, is identified with this state to the extent used in the state. If use cannot be determined there is a throw-out rule. Sec. 305 (1)(e)
- Receipts from sales of the performance of services are considered in this state if the recipient of the services receives all of the benefit of the services in this state. If the recipient of the services receives some of the benefit of the services in this state, the receipts are included in the numerator of the apportionment factor in proportion to the extent that the recipient receives benefit of the services in this state. Sec 305(2) provides for special and other rules for sales of certain securities related services and those for regulated investment companies. This rule for identifying the sale of a service to a state is different than the “cost of performance” test in the Single Business Tax. The new test has been referred to as a "market-based" method of sourcing sales to Michigan, in which sales are sourced based on the location of the purchaser or where the good or service is used. (This is similar to the sourcing of sales of tangible personal property both under the SBT and the bill.)
- Receipts from the origination of a loan or gains from the sale of a loan secured by residential real property are in this state if : (a) the real property is located in this state. (b) The real property is located both within this state and 1 or more other states and more than 50% of the fair market value of the real property is located within this state. (c) More than 50% of the real property is not located in any 1 state and the borrower is located in this state. Sec 305(3)
- Interest from loans secured by real property is in this state if the property is located within this state or if the property is located both within this state and 1 or more other states, if more than 50% of the fair market value of the real property is located within this state, or if more than 50% of the fair market value of the real property is not located within any 1 state, if the borrower is located in this state. The determination of whether the real property securing a loan is located within this state shall be made as of the time the original agreement was made and any and all subsequent substitutions of collateral shall be disregarded. Sec 305(4)
- Interest from a loan not secured by real property is in this state if the borrower is located in this state. Sec 305(5)
- There are several other provisions for the identification of particular kinds of sales receipts to the state.
- Spun-off corporations (Delphi and Visteon) are permitted to exclude from Michigan and total sales, for the purposes of calculating the sales factor, sales to the firm's immediately preceding former parent corporation. Sec. 307
- Following the provisions for sourcing sales to states, the act provides that all other receipts not otherwise sourced under this act shall be sourced based on where the benefit to the customer is received or, if where the benefit to the customer is received cannot be determined, to the customer's location. Sec 311.

7. Relief from Statutory Apportionment

A taxpayer may petition for relief from the formulary apportionment provided by the Act, but, pursuant to section 309(3):

(3) The apportionment provisions of this act shall be rebuttably presumed to fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of either tax base unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business activity transacted in this state and leads to a grossly distorted result or would operate unconstitutionally to tax the extraterritorial activity of the taxpayer.

Conclusion:

Out of state businesses with minimal contact with Michigan will often find their Michigan tax liability increasing by comparison to the former tax laws. Some credit provisions appear to exacerbate that result. There will doubtless be challenges to the new Act[3] Taxpayers are currently in the process of coming to understand the new tax, so that they may adjust their business affairs to avoid unnecessary taxation.

If you have any questions regarding this article, please contact the author, Robert F. Rhoades at 313.496.7608, rhoades@millercanfield.com, or any of our SALT tax experts:

Samuel J. McKim III at 313.496.7546, mckim@millercanfield.com; Joanne B. Faycurry at 313.496.7678, faycurry@millercanfield.com; Lynn A. Gandhi at 313.496.7527, gandhi@millercanfield.com; or Jackie J. Cook at 313.496.8468, cookj@millercanfield.com.

[3] The state has anticipated challenges to the extensive set of exemptions and credits in the Act and has in anticipation of such litigation provided a severance provision which provides:

Sec. 519. If a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired determines that any provision of this act that provides a deduction, credit, or exemption with respect to employment, persons, services, investment, or any other activity that is limited only to this state is unconstitutional or applies to employment, persons, services, investment, or any other activity outside of this state, that credit, deduction, or exemption shall be severed and shall not be in effect for any other tax year for which the final order shall apply, and the remaining provisions of this act shall remain in effect.