THE MICHIGAN DEPARTMENT OF TREASURY'S RECENT POST-*K-MART PROPERTY SERVICES* DECISION "LLC NOTICE" IS QUESTIONABLE, BOTH IN LAW AND POLICY.[1]

The *Kmart Michigan Property Services LLC v. Dep't. of Treasury* ("KMPS") Decision. On May 12, 2009, the Court of Appeals handed down its *KMPS* decision.[2] It ruled that a single member Limited Liability Company ("SMLLC") which had elected non-entity treatment under the Federal "check-the-box" regulations, cannot be required by the Michigan Department of Treasury's ("Department") RAB-1999-9 to be included in its owner's single business tax return ("SBT") when it wishes to file its own SBT return as a separate SBT taxpayer. On September 29, 2009, the Michigan Supreme Court denied the Department's application for leave to appeal.

The "Notice to Taxpayers Regarding *K-Mart Michigan Property Services, LLC v. Dep't. of Treasury*, the Single Business Tax, RAB 1999-9 and RAB 2000-5." (The "KMPS LLC Notice") Four months later, on February 5, 2010, the Department retaliated and issued its KMPS LLC Notice. Notwithstanding its far-reaching and extremely serious impact, the KMPS LLC Notice was not promulgated as a rule or even a "guideline" under the Michigan Administrative Procedures Act[3] and was not even published as a Revenue Administrative Bulletin permitted by the Revenue Act.[4] It is simply published as a "notice," for which there is no statutory authorization, basis or authority.[5]

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[2] 283 Mich App 647; 770 NW2d 915 (2009).

[3] MCL 24.201 *et seq*.

[4] MCL 205.3 permits the Department to "periodically issue bulletins that index and explain current department interpretations of current state tax laws.

[5] See McKim, S., "The Dubious Efficacy of Michigan Department of Treasury "Rules," "Revenue Administrative Bulletins," "Questions and Answers," and Other Publications", 60 The Tax Lawyer, pp. 1019, 1058-1073 (2007).

The KMPS LLC Notice is directed at taxpayers which were subject to the former SBT Act, which has been repealed for tax years beginning after December 31, 2007.[6] It does two things. First, it notifies SBT taxpayers that had included in their SBT returns a SMLLC which had elected non-entity treatment for federal income tax purposes, as was permitted by the Department's RAB 1999-9, that they must now file amended SBT returns excluding SMLLCs, treating them as non-included separate taxable entities.[7] These retroactively required amended SBT returns must be filed for all "open years," which would normally involve a four-year look-back,[8] unless that statute of limitations had been tolled by agreement, by pending audit or litigation or the period of limitations was extended due to fraud or an amendment to federal income tax return.[9] The amended SBT returns must be accompanied by all requisite additional SBT taxes with interest from the time the original return was due, with up to a 25% failure to file penalty if not filed by September 30, 2010.[10] Any refunds would be payable only if requested (and the filing of an amended return is such a request) within four years of the date the original return was required to be filed, as extended by any applicable tolling provisions.[11]

Second, the KMPS LLC Notice requires each of the SMLLCs which had elected non-entity treatment for federal income tax and which, as permitted by the Department's RAB 1999-9, had been treated as a division of its owner for the SBT return, to now file the individual entity SBT return, which it

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[6] Public Act 2006 No. 325, effective December 31, 2009 (MCL 208.151 *et seq*);

[7] The KMPS LLC Notice does not provide specific guidance with respect to consolidated or combined SBT returns under § 77 of the SBT Act (MCL 208.77) or which involve alternate allocation or apportionment approaches under § 69 of the SBT Act. (MCL 208.69.)

[8] The Department must assess a tax deficiency, interest, or penalty within four years of the date set for filing the return or the date the return was filed, which ever was later. (MCL 205.27a(2)) There is no specific statutory provision permitting the Department to require amended returns. SBT Act § 73 (MCL 208.73) prescribes the date for the final return but permits the Department "for good cause shown," to extend the date. The Department could look back to much earlier tax years if they were, for example, under certain types of audit or audit appeals. (205.27a(3))

[9] MCL 205.27a(2)-(4).

[10] MCL 205.24(2).

[11] MCL 205.27a(2)-(3).

would have filed had the Department not permitted its owner to include it in their SBT return as a non-entity. The KMPS LLC Notice announces that all such non-entity SMLLCs which were included in their owner's SBT returns, as permitted by RAB 1999-9, are now viewed as "non-filers."[12] The Department asserts that this permits it to retroactively assess for all "open years," permitting it to reach all the way back to the first tax year in which the non-entity SMLLCs were permitted to be included in their owner's return.[13] Since RAB 1999-9 was made retroactively effective to January 1, 1997, the Department would now require some LLCs to, by September 30, 2010, file their SBT returns and pay all SBT taxes and interest reaching back more than 12 years from the date of issuance of the KMPS LLC Notice. Interest is computed as with the single owner's amended return. The due date for the SBT returns for the SMLLCs is also September 30, 2010, and the same up to 25% failure to file (by September 30, 2010) penalty applies.

There are very serious legal and political[14] issues raised by the KMPS LLC Notice.

The KMPS LLC Notice is premised on several questionable legal assumptions which, hopefully, will soon be tested in a declaratory judgment proceeding to avoid the very burdensome compliance required by the KMPS LLC Notice and to repair, as much as possible, the tarnish to Michigan's reputation as a good state in which to locate and do business.

The KMPS LLC Notice Does Not Correctly Apply the Holding of the *KMPS* Decision. The primary, but by no means only, legal problem with the Department's KMPS LLC Notice is that it does not correctly apply the Court of Appeals' *KMPS* decision on which it purports to be based.

The *KMPS* decision held, at p. 5 of the slip sheet opinion,

> Looking simply at the provisions of the SBTA, KMPS was required to file an SBT return, regardless of its classification as a unregarded entity for

[12] The term "nonfiler" is not defined in either the Revenue Act (MCL 205.1 *et seq*.) or the SBT Act.

[13] Section 24(1) of the SBT Act (MCL 205.24) provides, *inter alia,* "If a taxpayer fails or refuses to file a return or pay a tax administered under this act within the time specified, the Department as soon as possible, shall assess the tax…"

[14] "Political" in the sense of what is "politic" for a State hoping to keep and attract businesses.

> federal tax purposes, because KMPS fit within the statutory definition of a "person" conducting business activity and the SBTA required all persons conducting business activity in the state to file a SBT return. Therefore the SBTA does not support the requirement of RAB 1999-9 that an organization that is a disregarded entity for federal tax purposes for a given taxable period must also file as a disregarded entity for state tax purposes. (Emphasis added.)

As the quoted excerpt from the *KMPS* decision shows, the Court of Appeals only held that the SBT Act does not permit the RAB 1999-9 "requirement" that a SMLLC opting to be treated as a disregarded entity for federal tax purposes, "must also file as a disregarded entity for state tax purposes." The *KMPS* decision did not hold that that SMLLC could not be permitted to file as a disregarded entity, only that it could not by the Department's RAB 1999-9 be required to so file.

The *KMPS* Decision Did NOT Hold That the Department Could Not Permit Non-Entity Treatment. The specific language in the *KMPS* decision's conclusion was not accidental. KMPS had argued in the Court of Appeals at length, that

> *KMPS* has never asserted that the Department is without authority to permit a limited liability company with one owner that elects to be treated as a division of its owner for federal income tax purposes to be treated for SBT purposes as a division of its owner. Kmart believes the contrary to be true…KMPS does not take issue with RAB 1999-9, save only that portion which incorrectly presumes that the Department has the power to force a limited liability company with one member-owner…to relinquish that status whenever it is a division of its owner for federal income tax purposes. (Appellee's Brief on Appeal, pp. 38-39.) (Emphasis added.)

Indeed, KMPS emphasized in the Court of Appeals that,

> A matter not involved in this appeal is whether the Defendant is empowered under the Revenue Act, MCL 205.1 *et seq*., or the SBT Act to permit a limited liability company with one member owner to elect to be treated as a division of its owner for SBT purposes. The Department did not raise this issue in the Tax Tribunal and has not listed it as required by

> MCR 7.212(C)(5) in the statement of questions here involved.[15] (Appellee's Brief on Appeal, p. 38.)

The only issue raised by the "Statement of Questions Involved" in the Department-Appellant's *KMPS* appeal Brief in the Court of Appeals was,

> Petitioner-Appellee, a single member limited liability company, elected to be treated as a disregarded entity for federal tax purposes. Does the SBTA require that it file its SBT return as a disregarded entity? (Appellant's Brief, p. v.)

KMPS had alerted the Court of Appeals to the fact that, "The Department has not asked this Court to determine whether it had the power to permit rather than require...single member limited liability companies to be treated as part of the business activities of the single member." (Appellee's Brief, p. 39.)

Accordingly, the Department, in issuing its KMPS LLC Notice, totally ignores the fact, of which it was well aware, that it did not in the *KMPS* case ask either the Tax Tribunal or the Court of Appeals to decide, and consequently neither had decided, that the Department could not permit a SMLLC which elected federal non-entity treatment to be included in its owner's SBT returns. This is a critical fact, as the Michigan Supreme Court has explained in *Breckon v Franklin Fuel Co.*, 383 Mich 257, 267; 174 NW2d 836 (1970), quoting from the United States Supreme Court,

> It is a maxim not to be disregarded, that general expressions in every opinion, are to be taken in connection with the case in which those expressions were used. If they go beyond the case they must be respected, but ought not control the judgment in a subsequent suit when the very point is presented for decision. The reasons for this maxim is obvious. The question actually before the court is investigated with care, and considered in its full extent. Other principles which may serve to illustrate it are considered in relation to the case decided, but their possible bearing on all other cases is seldom completely investigated. (Emphasis added.)

[15] Citing, *Preston v Dep't of Treasury*, 190 Mich App 491, 498; 476 NW2d 455 (1991) and *People v Yarborough*, 183 Mich App 163, 165; 454 NW2d 419 (1990).] The review by the Court of Appeals was limited to issues actually decided by the court below. [E.g., *Mich. Mutual Ins. Co. v. American Community Mutual Ins. Co.*, 165 Mich App 269, 277; 418 NW2d 455 (1987).]

The Supreme Court in a tax case held in *Howard Pore v. Comm'r. Revenue*, 322 Mich 49, 72; 33 NW2d 657 (1948),

> The opinion may not properly be construed as laying down a rule applicable in all cases involving the administering of the…tax law, without reference to the…questions raised. Moreover, if the language quoted from the opinion is construed as applicable to a situation of the character presented in the case at bar, it must to that extent be regarded as *dictum*. As indicated, however, it should not be interpreted as going beyond the scope of the matters before the Court for adjudication. The decision cannot be given the force and effect for which Plaintiffs contend.[16]

More recently, the Court of Appeals in *Martinelli v. Oakwood Hospital & Medical Center,* (Unpublished Opinion, Docket No. 283923; dec'd October 15, 2009), succinctly put it, "…statements regarding a rule of law that are not essential to the outcome of the case do not create a binding rule of law.... Further, a decision is not generally precedent with regard to a matter that was insufficiently argued and presented on appeal…"

The Portions of RAB 1999-9 Which Permitted Non-Entity Treatment for SMLLCs Were Not Invalidated By the *KMPS* Decision. The KMPS LLC Notice, after quoting the above *KMPS* holding, states,

> The Court of Appeals found in favor of KMPS, holding:
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> In accordance with *Kmart* and consistent with a series of cases that require the Michigan Department of Treasury (the "Department") to give judicial decisions full retroactive effect – even in the presence of contrary guidance issued by the Department prior to the date of the decision – the Department concludes that *Kmart* will be applied to all open tax years.
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> Those portions of RAB 1999-9 and RAB 2000-5 dealing with the requirement that an entity disregarded for federal tax purposes for a given taxable period must also file as a disregarded entity for state tax purposes are invalid to the extent inconsistent with *Kmart*. (Emphasis added.)

[16] The Supreme Court in *McNally v. Wayne County Commr's*, 316 Mich 551, 558; 25 NW2d 513 (1947), explained, "It is a well-settled rule that any statements and comments in an opinion concerning some rule of law or debated legal position not necessarily involved or essential to determination of the case in hand are, however, illuminating, but *obiter dicta* and lack the force of an adjudication."

The KMPS LLC Notice did correctly "invalidate" only, "Those portions of RAB 1999-9…dealing with the requirement that an entity disregarded for federal tax purposes…must also file as a disregarded entity for state tax purposes are involved…" Accordingly, those portions of the RABs which state what the Department will PERMIT as opposed to require, are still in place and must be viewed as valid. The Department has assured taxpayers that they may rely on its RABs, which the Department has assured it will give the "status of precedent," the taxpayer being cautioned to consider the affect of subsequent court decisions.[17] Yet this fact notwithstanding, and having expressly acknowledged that the *KMPS* decision is limited to its power to require, not to its ability to permit, the Department is nevertheless attempting to impose – retroactively – extremely burdensome, and doubtless for some taxpayers extremely costly, new and amended return requirements, effectively ignoring (or reneging on) its published RAB 1999-9 permission.

It is difficult to reach a conclusion other than the Department is acting disingenuously. The Department is well aware that it cannot legitimately cite the *KMPS* decision as binding judicial authority for what it now represents as the holding it is "required" to follow.

The Department Is Again Playing the "Bait and Switch" Game. Were the *KMPS* decision a binding precedent holding that the Department's RAB 1999-9 notwithstanding, it cannot permit a SMLLC to file an SBT return as a non-entity with its owner, which it clearly is not, even then there is serious doubt whether the Department can correctly state that it is required to give the judicial decision, what it calls, "full retroactive effect." It cites decisions which hold that it can do this, but which did not hold that it is required

[17] RAB 1989-34 states, "A Revenue Administrative Bulletin states the official position of the Department, has the status of precedent in the disposition of cases unless and until revoked or modified and may be relied on by taxpayers in situations where the facts, circumstances and issues presented are substantially similar to those set forth in the Bulletin. A taxpayer must consider the affect of subsequent…court decisions…when relying on a Revenue Administrative Bulletin." PA 2006 No. 12, effective February 3, 2006, which provides a taxpayer "may rely upon…and shall not be penalized: for reliance on a bulletin issued by the Department after September 30, 2006," is probably inapplicable. See McKim, The Sometimes Dubious Effect of Michigan Department of Treasury "Rules," "Revenue Administrative Bulletins," "Letter Rulings," "Questions and Answers," and Other Publications, *supra* fn 5, pp. 1065-1068.

to do this. It cites, but conveniently ignores, the statement in *J. W. Hobbs v. Department of Treasury*, 269 Mich App 38, 47; 706 NW2d 460 (2005), squarely on point,

> We note that defendant was correct in asserting that this Court allowed for a retroactive application of the taxing standards in *Gillette*. However, this Court did not conclude that this retroactive application was required. Thus, while defendant had the authority to retroactively apply the new taxing standard, such application was not mandatory. Though we are bound to uphold defendant's retroactive application of the SBT, we note that it is unfortunate that plaintiff and other similarly situated businesses are not able to trust the published bulletins of defendant. Defendant's decision to retroactively apply the new standard has blindsided plaintiff which had correctly complied with the previous taxing standards and planned its business accordingly. (Emphasis added.)

The Court there also noted its "…shared disgust of the 'bait and switch' tactics of defendant" the Department.

The Department Ignores What It Earlier Asserted Were Considerations of Due Process and Taxpayer Reliance. In terms of its past practice in a similar situation, the Court of Appeals in *Gillette Co. v. Dep't. of Treasury*, 198 Mich App 303; 497 NW2d 595 (1993), held the Department was applying the wrong (PL 86-272) jurisdictional test, resulting in thousands of out-of-state businesses which had relied on the Department's RAB 1989-46 and SBT 1980-1 Bulletin, becoming subject to Michigan's SBT jurisdiction. In that situation, the Department issued notices that it would only apply the new jurisdictional tests retroactively to 1989, four years before the 1993 *Gillette* decision was handed down, notwithstanding that such "non-filers" were technically liable all the way back to 1976, when the SBT was first enacted. The Department asserted that it decided not to impose retroactive jurisdiction for all "open years" because of "consideration of due process, availability of records, the non-filing potential taxpayers' reliance on respondent's [Department's] bulletins, and respondent's limited resources."[18] The Department there did not

[18] *Syntex Labs v Dep't of Treasury*, 233 Mich App 286, 291; 590 NW2d 612 (1998). In *Syntex* the Court also found, at p. 293, "Respondent [Department] did not forgive liability for unpaid taxes for years before 1989, but rather made a decision regarding how to allocate its resources to achieve maximal compliance."

feel that it was "required" to pursue "nonfilers" for all "open years," and the cases it cited to that effect in its KMPS LLC Notice did not so hold.

Accordingly, in its KMPS LLC Notice, the Department, ignoring its past practice and ignoring the advice of the Court of Appeals in *Hobbs v. Dep't. of Treasury* (a decision it relies upon as authority in support of its KMPS LLC Notice), now attempts to impose the obligation on all non-entity SMLLCs to retroactively file new SBT returns for all open years, presumably reaching back over 12 years to 1997, when it first assured these SMLLCs that they could rely on its written and published assurance that they would be permitted to file as non-entities.

SMLLCs Included In Their Owner's SBT Returns Are Not "Non-Filers." Likewise, on questionable legal grounds, is the Department's assertion in its KMPS LLC Notice that "previously disregarded entities are considered non-filers for statute of limitations purposes…" This treats these SMLLCs, which were included in their owners' SBT returns as was permitted by RAB 1999-9, as if they never filed SBT returns at all. But the items which would have been part of their SBT "tax base" were included in calculating their owner's SBT tax base, as were the items which would have been included in calculating their apportionment factor. The "value added" by the single member LLC was included in and subject to the SBT tax as a part of its single owner's SBT return.[19] It is one thing to ask the SMLLCs to file SBT returns reflecting their separate taxpayer status. It is a very different thing to assert that they must be treated as "non-filers" liable for "open" years as far back as 1997, thirteen years earlier. This challenges traditional concepts of fundamental justice.

The Department Will Collect Interest On Retroactive Taxes Due, But Pay None On Retroactive Refunds. According to the KMPS LLC Notice, interest will be added to the SBT taxes due on the retroactively required new or amended returns "from the time the tax was originally due," meaning the

[19] Section 80 of the SBT Act (MCL 208.80) mandates that the "Department shall prescribe forms for use by taxpayers, and shall promulgate rules in conformity with this act for…the making of returns…"

time the tax would have been paid if the Department had not stated it would permit non-entity SMLLCs to file with their owners.[20] Interest on any retroactive return refund, however, does not begin to run until 45 days after the claim for refund is filed, which would presumably be the day the retroactive SBT return is filed.[21]

The Department's "Penalty" Threats. Lastly, the Department's arbitrary September 30, 2010, filing deadline for SMLLC returns and amended returns of the LLC's single owners is enforced with a threatened "failure to file" penalty. It is by no means certain that such penalties can be asserted with respect to an administratively issued retroactive "notice" requiring new or amended returns by an arbitrary date. A failure to file/pay penalty could be as much as 25%.[22] The Department views this as a "non-discretionary" penalty. This view notwithstanding, Section 28(1)(e) of the Revenue Act (MCL 205.28) specifically permits the Department to "compromise…interest or penalties, or both." This would seem to be an appropriate time for the Department to waive some or all of the interest and to reduce the 50% non-filing penalty for those which have legitimate difficulty meeting the arbitrary September 30th deadline. The problem is solely of the Department's creation. Further, the positions it has taken in the KMPS LLC Notice are of seriously questionable validity.

The Department's Requirements Are Inequitable. It is difficult not to conclude that the KMPS LLC Notice is an attempt by the Department to raise additional funds at the expense of those who trusted and relied on the Department[23] and the reputation of this State as a good place in which to do business. This is particularly so because the problem was created by the taxpayers' reliance on the Department's RAB 1999-9, which it had been advised, in RAB 1989-34, "has the status of precedent in the disposition of

[20] MCL 205.23(2) and 205.24(2).

[21] MCL 205.30(3)

[22] MCL 205.24(2) (See also, RAB 2005-3.)

[23] See fn 16, *supra*.

cases" and "may be relied on by taxpayers in situations where the facts, circumstances and issues presented are substantially similar to those set forth in the Bulletin." While RABs are merely notices of the Department's "interpretation of current state tax laws,"[24] and are therefore arguably not legally (as opposed to equitably) binding on the Department, the Department should bear the responsibility for its practice of using such "bulletins" rather than seeking a legislative amendment, or even promulgating a rule or guideline adopting the federal single member LLC "check-the-box" approach for purposes of the SBT Act.[25]

Uniform Administrative Difficulties and Inequities. If the existence of an included "nonentity LLC" is not highlighted in its owner's SBT returns, it could be relatively difficult for the Department to fairly enforce its administrative retroactive dictates. After the *Gillette* decision in 1993, the Department did a computer sweep comparing its list of employers filing income tax withholding returns with those filing SBT returns, notifying those on the first but not the second list of potential four-year retroactive SBT liability. A similar procedure here may be considerably more difficult, given that such SMLLCs may never have filed separate SBT or withholding returns. Even if the owner could be ascertained from state records, those records would not likely identify the check-the-box status for federal income tax, nor would they establish if the owner was a Michigan SBT taxpayer required to file SBT returns. Problems less administratively difficult than those in the past, in the *Gillette* retroactive revocation of RAB 1989-46 (PL 86-272) jurisdiction test situation discussed above, gave rise to arguments by the Department that it did not have the staff or the resources to enforce the new retroactive jurisdictional test uniformly for all "open years."[26] Unless it can do so here, the Department is creating serious inequalities which should not be a part of the administration of a unique business tax which was repealed almost three years ago.

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[24] MCL 205.3(f)

[25] Under the Administrative Procedures Act [MCL 24.203(6)], such a "guideline" is statutorily established as binding on the agency but not any other person. A rule promulgated under that Act might be deemed to be legislative and may have been given the "force of law." See McKim, *supra*, fn 5, p. 1029.

[26] See fn 17, *supra*.

Potential Unconstitutional Double Taxation. There are numerous other problems and unanswered questions raised by the approach the Department has taken in the KMPS LLC Notice. For example, the LLC owner can only be expected to amend, and can only seek refunds, for the four years (as extended) open under the statute of limitations.[27] Yet the Department asserts that the disregarded entity is required to file its retroactive individual returns for all open years as far back as 1997. Since the SBT was repealed for years beginning after 12/31/07, presumably for some owners, only tax years 2005 and 2006 remain open. Yet the disregarded entity involved is, according to the Department, liable for all years during which it was included in its owner's SBT return, back to the 1997 effective (retroactive) date of RAB 1999-9. Therefore, the LLC could be liable for the payment of SBT taxes for several years, even though its owner had included its "value added" (or "gross receipts") in its SBT returns for those years, now beyond the statute of limitations, and had paid some or all of the requisite SBT taxes on that value added (or gross receipts). In these circumstances, unconstitutional double taxation could result,[28] as would as yet other serious issues.[29]

Conclusion. Should the KMPS LLC Notice approach not soon be rejected by the Courts or the Legislature, it will do irreparable damage to this State's reputation in the national and international business community, not to mention to those local businesses which trusted the Department to honor its commitments. While some additional tax revenue may be gleaned, it will not even approach the damage

[27] MCL 205.27a(2).

[28] See, e.g., *C. F. Smith Co. vs. Fitzgerald*, 270 Mich 659; 259 NW 352 (1935).

[29] What happens if the disregarded entity has no records available to it from 1997, twelve year old records having been destroyed? What happens if the LLC was terminated ten or eleven years ago? Who then is responsible for filing its SBT return and paying the taxes and penalties? Is there a carryforward to the owner's amended SBT returns from earlier years' returns, which are beyond the statute, to reflect the exclusion of the LLC from those earlier returns? How are intra-entity transactions treated which were "washed out" when the LLC was included as a division of its owner, information as to which may no longer be available?

this ill-advised and probably illegal administrative position will do to the State of Michigan in both the short and long term.[30]

[30] Members of the Miller, Canfield, Paddock and Stone State and Local Tax Practice Group are acting for a growing number of concerned taxpayers in exploring possible legislative approaches to resolving or ameliorating the problems caused by the Department's KMPS LLC Notice.