



BDO Seidman, LLP
Accountants and Consultants

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State and Local Tax Alert

Subject:

New Michigan Business Tax Signed into Law

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On July 12, 2007, Michigan Governor Jennifer Granholm signed into law a new business tax act to replace the Michigan Single Business Tax, effective January 1, 2008. The new tax act has two components, income and modified gross receipts, and is imposed on individuals and all entity types with business activity. Combined filing is required for unitary business groups. Insurance companies and financial institutions are subject to specific industry taxes. Several new and existing credits are available. Additionally, with the shift to an income tax, there are possible financial statement impacts to be considered, such as deferred taxes and FIN 48.

Background and Facts

The Michigan Single Business Tax ("Michigan SBT") was implemented in 1976 as a replacement for several business taxes, as well as the corporate income tax. On August 9, 2006, the legislature approved a bill to repeal the Michigan SBT after December 31, 2007. Since then, the legislature has been attempting to devise a replacement tax for the Michigan SBT. On July 12, 2007, the Governor signed Senate Bill 94, establishing the replacement tax, known as the "Michigan Business Tax" or "MBT."

Effective Date

The new MBT is effective beginning on January 1, 2008. Therefore, for a taxpayer with a fiscal year end, business activity for the period prior to January 1, 2008 will be subject to Michigan SBT with business activity for the period after December 31, 2007 will be subject to MBT.

"Taxpayer" Under the MBT

The bill defines a "taxpayer" as a "person or a unitary business group liable for a tax" under the new MBT Act. A person is defined to be an "individual, firm, bank, financial institution, insurance company, limited partnership, limited liability partnership, copartnership, partnership, joint venture, association, corporation, subchapter S corporation, limited liability company, receiver, estate, trust, or any other group or combination of groups acting as a unit." Although financial institutions and insurance companies are included in this definition, these entities are subject to industry-specific taxes outlined below.

Components of the MBT

The MBT is comprised of two components: an income tax and a modified gross receipts tax. Taxpayers that have nexus for both types of taxes are

required to pay **both** taxes, as this is not a “greater of” calculation. Unitary business groups are required to file on a combined basis for both types of taxes.

Income Tax

The income tax is imposed at the rate of 4.95% on business income after allocation and apportionment. It is imposed on every taxpayer with “business activity” within Michigan, unless prohibited by federal Public Law 86-272.

Business income generally means that part of federal taxable income that is derived from business activity, with several adjustments. Adjustments before apportionment include adding back:

- Interest income and dividends derived from obligations or securities of states other than Michigan;
- Taxes on or measured by net income, including the entire MBT liability;
- Carryback or carryover of a net operating loss, to the extent deducted for federal taxable income purposes; and
- Royalties, interest, or other expense paid to a related person for the use of an intangible asset if the person is not included in the taxpayer’s unitary business group (with certain exceptions).

Deductions from federal taxable income before apportionment, to the extent included in federal taxable income, include:

- Dividends (including deemed dividends and Section 78 Gross Up) and royalties received from foreign persons;
- Income (add back loss) attributable to another entity whose business activities are taxable or would be subject to tax if business activities were in Michigan;
- Interest income from U.S. obligations; and
- Earnings that are net earnings from self-employment, except to the extent that those net earnings represent a reasonable return on capital.

The income tax base is further reduced, after apportionment, by Michigan business losses incurred after December 31, 2007. There is a carryforward period of any unused business losses for a period of 10 years.

Modified Gross Receipts Tax

The modified gross receipts tax is imposed on all taxpayers with gross receipts sourced to Michigan exceeding \$350,000 that have a physical presence in Michigan of one or more days OR that actively solicit sales in the state. Physical presence can be created by an employee or independent representative acting on behalf of the taxpayer, but does not include professional services provided to a taxpayer not significantly associated with the taxpayer’s ability to establish and maintain a market in Michigan.

The modified gross receipts tax is imposed at the rate of 0.8% of a taxpayer’s gross receipts, less purchases from other firms. “Purchases from other firms” includes items such as inventory, depreciable assets, and other materials and supplies, including fuel and repair parts. Staffing companies are allowed a deduction for the compensation paid to personnel provided to their clients as well.

For the 2008 tax year, taxpayers are also allowed a deduction of 65% of any remaining Michigan SBT business loss carryforward that was generated in either tax year 2006 or 2007. If the taxpayer is a unitary business group, the business loss carryforward must be deducted against the modified gross receipts tax base of the person that generated the business loss.

Unitary Business Groups

The bill requires combined filing for both taxes for “unitary business groups.” Unitary business groups are determined based on an ownership test of more than 50%, and a flow of value or the dependency and contribution considerations between or among entities. Individuals and all entity types with business activity can be included in a unitary business group (e.g. S corporations with C corporations), but foreign operating entities, financial institutions and insurance companies are not allowed to be part of a unitary business group.

In a unitary business group, all transactions between members of the group are eliminated from both income and modified gross receipts tax bases, as well as the apportionment factor. The bill provides that each entity included on the combined return is to be treated as a single entity, which appears to indicate that although there is a single tax base before apportionment for the unitary group, each entity will calculate its own apportioned income and MBT liability.

Apportionment

All multistate taxpayers are allowed to apportion both the income and modified gross receipts tax bases. The apportionment factor is determined solely by the sales factor. For unitary groups, sales to Michigan are included in the numerator whether or not the person with the sales has nexus in Michigan (i.e. *Finnigan* rule). It is not clear from the bill whether or not there will be one apportionment factor for the entire combined group or if each entity will use its own numerator and the group's denominator, which is the typical combined apportionment approach. There are also special apportionment provisions for several specific industries, including the transportation industry.

For sourcing sales of tangible personal property for sales factor numerator purposes, a destination rule is provided for in the bill, which is the same as applied to the Michigan SBT. However, for sales of services and intangible property, the bill provides for a market-based approach. This means that receipts are sourced to Michigan if the location of the purchaser or the good or service are used in Michigan, in proportion to the extent that the recipient received benefit of the services in Michigan.

Credits

Several tax credits are provided in the bill. Some credits are newly established with the bill and some credits that existed under the Michigan SBT continue to be available under the MBT.

New tax credits include:

- *Compensation credit.* The rate is 0.37% and is allowed against wages paid to employees in Michigan. In the case of a professional employer organization (PEO), the compensation credit available to the PEO will not include compensation payments made for employees provided to clients of the PEO; alternatively, the client can take a credit for the compensation paid by the PEO to the employees provided to the client company under the employee leasing arrangement.
- *Investment tax credit.* The rate is 2.9% of the cost of new capital assets located in Michigan, less any recapture. The aggregate credit claimed under this and the compensation credit provision together cannot exceed 65% of the taxpayer's total tax liability.
- *Research and development credit.* The rate is 1.9% of all research and development expenses in Michigan in the tax year. This credit, combined with the first two credits above, cannot exceed 75% of the taxpayer's total tax liability. A second R&D credit is available for the 2008-10 tax years, equal to 30% of the amount of an "eligible contribution" made to certain small business engaged in R&D. This refundable credit is limited to \$300,000 per taxpayer. The Michigan Economic Growth Authority is responsible for approving this credit and cannot grant more than 20 per year.
- *Filing threshold/phase-in credit.* This credit is provided to taxpayers who have gross receipts apportioned to Michigan between \$350,000 and \$700,000. The credit is calculated by taking the taxpayer's tax liability after the small business credit and multiplying it by a fraction, the numerator being the difference between \$700,000 and the taxpayer's apportioned gross receipts and the denominator being \$350,000.
- *Personal property tax credit.* This is a credit of 35% of personal property taxes levied after December 31, 2007 on industrial personal property located on industrial real property and is refundable. Other credits are allowed for utility companies.
- *Entrepreneurial credit.* This credit of 100% of the increased tax liability attributable to the increase in employment is available only in tax years 2008-2010. To qualify, taxpayers must have: (1) had gross receipts of less than \$25 million in the preceding tax year; (2) created or transferred to Michigan at least 20 new jobs during the preceding tax year; and (3) made at least \$1.25 million in capital investment in Michigan during the preceding tax year. The credit is generally not available to retail establishments if they are part of a franchise or a unitary business group.
- *Arts/culture credit.* The bill provides for a nonrefundable credit for donations made to a municipal or nonprofit art, historical, or zoological institute. The credit is equal to half of the amount contributed above \$50,000 and is capped at \$100,000.
- *Special sector credits.* The bill provides several business sectors with specific credits against the new MBT liability. The sectors include new motor vehicle dealers, grocery stores headquartered in Michigan, stadium owners, and the Michigan International Speedway. All of these credits are nonrefundable and may not be carried forward.

Several tax credits that currently exist under the Michigan SBT were extended to apply to the new Michigan Business Tax, including:

- Investment tax credit (see above for changes)
- Startup business credit
- Michigan early stage venture credit
- Public contribution credit (maximum amount increased from \$5,000 to \$10,000)
- Workers' disability compensation credit
- Community foundation contribution credit (expanded to include donations to education foundations)
- Food bank and homeless shelter contribution credit
- Next Energy credit
- MEGA credits
- Renaissance zone credit
- Historic preservation credit
- Brownfield credits
- Hematite ore credit

Small Business Provisions

Under the bill, small businesses must meet the following limitations to be eligible for a reduced rate of 1.8% on "adjusted business income":

- Business income: less than \$1.3 million (increased from \$475,000)
- Officer compensation: phase-out range is \$160,000-\$180,000 (increased from \$95,000-\$115,000)
- Gross receipts: phase-out range is \$19 million - \$20 million (increased from \$9 million - \$10 million)

An entity that meets the above criteria is allowed a small business credit to reduce its tax liability to the effective rate of 1.8% of adjusted business income (see Section 417(9)(b) of the bill for a definition of "adjusted business income"). If a taxpayer is eligible to take this credit, it is not required to compute its liability that would have been due under the income and modified gross receipts tax provisions.

Specific Industry Taxes

Insurance Companies

Insurance companies are exempt from the income and modified gross receipts tax. Previously, insurance companies were subject to a total tax of 1.0735% of adjusted receipts. Under the new law, insurance companies will be subject to a 1.25% tax on gross direct premiums written on property or risk located in Michigan. The bill retains many industry-specific credits and contains a provision allowing the new compensation credit in certain situations.

Insurance companies will now be subject to sales and use taxes, in addition to real and personal property taxes as they were previously. As with the current law, insurance companies based in other states will be required to pay the greater of the MBT or the insurance retaliatory tax. Additionally, insurance companies will continue to be required to use a calendar year end.

Financial Institutions

Financial institutions are also exempt from the income and modified gross receipts tax. "Financial institutions" include bank holding companies, banks, and savings and loan holding companies. The bill does not include provisions allowing a company that has 90% of its assets and receipts from intangibles to be considered a financial institution (i.e. the previous financial organization 90/90 provision).

Financial institutions will be subject to a 0.235% franchise tax on the value of their net capital stock. Net capital stock is determined by taking the taxpayer's equity, less the cost of goodwill and U.S. and federal obligations. Each year, the value of net capital is calculated by taking an average over the past five years. Nexus for the franchise tax on financial institutions is determined the same way as nexus for the modified gross receipts tax. For multistate taxpayers, the tax base is apportioned based on the gross business factor (see Section 269 in the bill for the definition of "gross business"). Financial institutions that constitute a unitary business group are required to file a combined return.

Filing of Returns

Annual returns, for all but insurance companies, are due on the last day of the fourth month after the end of the taxpayer's tax year (as they currently are under the Michigan SBT). An extension of the due date is available with a federal extension. The due date is automatically extended until the last day of the eighth month following the original due date of the return (12/31 for calendar year taxpayers). Estimated tax payments of 25% of the estimated annual liability are due on the 15th day of the fourth, seventh, tenth, and thirteenth months following the end of the taxpayer's tax year. Insurance companies are required to file annual MBT returns before March 2 after the end of the tax year and no extensions provisions are provided.

For the implementation year, fiscal year filers will be required to file a final short period return for the period ending December 31, 2007, and an initial short period MBT return for the period from January 1, 2008 through its fiscal year ending in 2008. The bill provides that a fiscal year taxpayer can calculate its MBT liability for the initial short period based on either the prorated income and modified gross receipts or on the actual income and modified gross receipts for the short period.

Revenue Sharing

The bill places a limit on the amount of revenue the new MBT can generate in fiscal years 2007-08, 2008-09 and 2009-10. If revenue exceeds the specified limit in any of these three years, 50% of the excess will be refunded to taxpayers and the remainder will go into the Budget Stabilization Fund (BSF). If the limit is exceeded by less than \$5 million, then all of the excess over the limit will be deposited into the BSF.

Personal Property Tax Relief

The new Michigan Business Tax Act was passed as a package of bills, including Senate Bill 94 (discussed above), and House Bills 4369-4372. These House Bills provide for industrial and commercial personal property tax relief.

How BDO Seidman Can Help

With the signing of Senate Bill 94, Governor Granholm overhauled the taxing system on business entities in Michigan. The new statutes will need to be reviewed to determine their impact on your company's Michigan tax liability. Additionally, since a component of the MBT is a tax based on income and most taxpayers in the past treated the Michigan SBT as a non-income tax, both FIN 48 and deferred tax assets/liabilities will likely need to be considered for the first time.

BDO Seidman state tax professionals can assist your company in determining the impact of the Senate Bill 94. We will be providing both live and internet-based seminars going over the details of the new MBT and other aspects of Senate Bill 94, and will send out invitations once the dates and locations are finalized.