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AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

MICHIGAN CORPORATE INCOME TAX: PASSAGE OF BILLS RESULT IN EXEMPTION OF DISCs, MODIFICATION OF SALES FACTOR ELIMINATIONS, AND VARIOUS OTHER "CLEAN-UP" ITEMS

SUMMARY

On February 25, 2014, Michigan Governor Rick Snyder signed into law House Bill 5010, which made two significant changes to the Michigan Corporate Income Tax ("CIT"): (1) domestic international sales corporations ("DISCs") are now included as entities exempt from the CIT; and (2) sales between a taxpayer and a unitary flow-through entity ("FTE"), or between two FTEs unitary with the taxpayer, are only eliminated to the extent of the taxpayer's interest in the FTE (or selling FTE, if the sale is between two FTEs). Also on February 25, 2014, the governor signed into law House Bills 5008, 5009, and 5011, which address various CIT issues, including clarifying the definitions of "ultimate destination" for sales-factor purposes and "officer" for purposes of the small business credit. The bills also create a successor mechanism for business loss carry forwards in certain reorganizations, add to the intercompany transaction exclusion and revise the credit recapture provisions for the investment tax credit ("ITC").

DETAILS

DISC Treatment under CIT (H.B. 5010)

Under Internal Revenue Code section 991,[1] a corporation that qualifies as a DISC under section 992 is not subject to federal income tax. One of the criteria under section 992 is that a DISC is a United States domestic corporation and must be classified as a C corporation for federal tax purposes, *i.e.*, it cannot be an S corporation or partnership. DISCs are mechanisms

[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended.

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through which United States businesses are provided subsidies for exporting products made domestically. As permitted by federal tax law, DISCs are paper entities that simply receive commissions based on products sold by a “related supplier” overseas. The related supplier pays the DISC a commission for the export sales and related expenses and the DISC reports that amount as income. Because the DISC is not subject to federal income tax, that income is not taxed when received by the DISC. Rather, the DISC makes a distribution of its income to its shareholders, which is subject to individual income tax as dividend income.

For many companies utilizing a DISC, the DISC is a corporation in a vertical chain of ownership. One common structure used is to have the S corporation related supplier directly owning the DISC. However, there are also brother-sister DISC structures in which the same shareholders own the DISC and the related supplier. As noted above, the DISC must be a corporation, but the related supplier’s income tax classification depends on how the entity is treated for federal income tax purposes. The related supplier can be treated as a partnership, S corporation, or C corporation for federal income tax purposes, depending on the organization of the entity and the election, if applicable, made by the entity.

Under the predecessor to the CIT, the Michigan Business Tax (“MBT”), a DISC was not among the list of exempt entities. Also under the MBT, the definition of a “person” included S corporations and partnerships. Given the interrelated activities of a DISC and its related supplier, in most situations, the DISC and its related supplier would have satisfied the tests contained within the unitary business group (“UBG”) definition. Meeting the UBG requirements meant that the DISC and its related supplier were required to file a combined report for MBT purposes, offsetting or eliminating all transactions between them. Given the combined reporting rules, a DISC generally would not have been required to file a separate MBT return and thus there was no tax due specifically by the DISC. Rather, the MBT impact was that the benefit of paying the DISC commission from the related supplier to the DISC was eliminated.

Similar to the MBT, prior to the enactment of this legislation, a DISC was not included in the list of entities exempt from CIT under MCL § 206.625(1). However, under the CIT, only entities taxed as C corporations for federal income tax purposes are considered “persons.” Therefore, for those DISC structures with an S corporation or partnership related supplier, the DISC was required to file as a stand-alone entity and pay CIT on its commission income, assuming it met the filing thresholds.

With the enactment of this legislation, the list of exempt entities under MCL § 206.625(1) now includes the following:

> A person that qualified as a domestic international sales corporation as defined in section 992 of the internal revenue code for the portion of the year that it has in effect a valid election to be treated as a domestic international sales corporation.[2]

Therefore, a DISC that would have previously been required to file a separate CIT return to pay tax on its commissions will no longer be required to file a CIT return. For a DISC that is a brother-sister corporation to its related supplier that is also a C corporation and was previously filing a combined report with its related supplier, it is unclear whether or not the DISC will still be a member of the UBG. It is important to note that this legislative change did not affect the definition of the term “person” or the members of a UBG. Therefore, it is likely that, even if the DISC’s activities would be excluded from the combined report, the transactions between it and its C corporation related supplier may be required to be eliminated (*e.g.*, the commission expense would be eliminated) because the DISC may still be considered part of the UBG.[3] This change is effective retroactively to taxable years beginning after December 31, 2011.

Sales Factor Elimination Modified (H.B. 5010)

Under CIT, a multistate taxpayer that owns an interest in an FTE that is unitary with the taxpayer is required to include the taxpayer’s proportionate share of the FTE’s sales for sales-factor purposes in determining the taxpayer’s CIT liability.[4]

[2] MCL § 206.625(1)(d).
[3] Currently, there is no guidance as to whether the DISC would still need to be listed on the combined report and report zero activity or would simply not be included on the combined report.
[4] MCL § 206.663(1).

Prior to the enactment of this legislation, all sales between the taxpayer and a unitary FTE were eliminated under MCL § 206.663(2) in determining the taxpayer's apportionment factor, irrespective of the level of ownership in the FTE. Additionally, all sales between FTEs unitary with the taxpayer were eliminated in full.[5]

With this legislation, sales between the taxpayer and unitary FTEs will now be eliminated *only to the extent of the taxpayer's interest in the FTE*. Similarly, sales between two FTEs unitary with the taxpayer will now be eliminated *only to the extent of the taxpayer's interest in the selling FTE*. This change is effective retroactively to taxable years beginning after December 31, 2011.

Various CIT Clean-Up Modifications (H.B. 5008)

Prior to the enactment of this legislation, for CIT purposes, there was no provision allowing the carryover of a business loss deduction to a taxpayer that acquired the assets of another corporation that had a business loss carryover. Under this legislation, a taxpayer that makes an acquisition of assets of another corporation that has a business loss may deduct the business loss attributable to that distributor or transferor corporation. This assumes that the transaction qualified under section 381(a)(1) or (2).[6]

Prior to the enactment of this legislation, for CIT apportionment purposes, sales of tangible personal property are sourced to Michigan if the property is shipped or delivered to a purchaser in Michigan based on the "ultimate destination at the point that the property comes to rest regardless of the free on board point or other conditions of the sales."[7] With the enactment of this legislation, the term "ultimate destination" is clarified for purposes of determining the sales factor numerator. Notably, property stored in transit for 60 days or more prior to the purchaser or purchaser's designee receiving it, or not picked up for 60 days or more for dock sales, is considered to have come to rest at its ultimate destination. This means the sale would be sourced to that location, even if the property is eventually shipped or taken to another jurisdiction.

Also with the enactment of this legislation, part of the definition of an officer has been amended to read "[p]ersons performing similar duties **and responsibilities** to persons described in subparagraphs (i) and (ii), **that include, at a minimum, major decision making**"[8] (emphasis added). This definition is applicable for a taxpayer that is determining its eligibility for taking the alternative small business credit, which allows a taxpayer to calculate its CIT liability as 1.8% of its adjusted business income. One of the criteria that must be met to be eligible for the credit is that no officer may be allocated income exceeding $180,000 (and the credit phases out for income levels exceeding $160,000).

All of the changes in House Bill 5008 are effective retroactively to taxable years beginning after December 31, 2011.

Intercompany Transaction Exclusion (H.B. 5009)

Prior to the enactment of this legislation, for CIT purposes, all transactions between persons included in the UBG were required to be eliminated from the CIT base and apportionment formula. With this legislation, all transactions between persons included in the UBG are also eliminated for purposes of determining exemptions, credits, and the filing threshold. NOTE that this change, unlike the other bills detailed in this alert, is *effective for taxable years beginning after December 31, 2013.*

[5] Note that if a filer is a UBG, the UBG is considered the "taxpayer" such that sales between any member of the UBG and a FTE would be eliminated.
[6] MCL § 206.623(4).
[7] MCL § 206.665(1)(a).
[8] MCL § 206.671(9)(g)(iii).

ITC Recapture Modifications (H.B. 5011)

Prior to the enactment of this legislation, for CIT purposes, taxpayers were required to recapture some of the ITC taken on tangible personal property during MBT and Single Business Tax ("SBT") years, if certain criteria were met.[9] The original statute provided a limitation related to the recapture of ITC taken on SBT returns, but not for ITC taken on MBT returns. For SBT returns, the recapture was limited to the extent the credit was used, *i.e.*, a tax benefit rule. For MBT returns, however, this language was excluded, so that, even if a taxpayer had initially realized no benefit from the acquisition of assets eligible for ITC on its MBT return, recapture would still have been required on the future CIT return upon disposition of those assets. With the enactment of this legislation, the recapture calculation has been slightly modified and the amount of recapture is limited to the extent the credit was used under both SBT and MBT. This change is effective retroactively to taxable years beginning after December 31, 2011.

BDO INSIGHTS

If a taxpayer filed a stand-alone CIT return for a DISC for any taxable periods beginning after December 31, 2011, there are likely some refund opportunities available. If estimated tax payments have been made for the current taxable year, consult your tax advisor as to how best to request a refund of these amounts. The DISC should also consider filing Form 163, Notice of Change or Discontinuance, in order to close the DISC's CIT account. (The taxpayer may want to wait until all refunds have been received, however.) If a combined CIT return was filed, including a DISC, affected taxpayers may want to review the return to determine if there is any tax impact. On the returns that were properly filed as combined returns including the DISC and its related supplier prior to this change, however, there may be no tax impact of this law change depending on how the UBG elimination rules are interpreted in connection with this exemption. This UBG anomaly only exists in the context of a DISC that has a related supplier that is treated as a C corporation for federal income tax purposes. Taxpayers should also analyze whether any adjustments will need to be made to the commission amount allowed, if commission amounts have been increased to include other costs incurred by the DISC, such as state income tax expense.

With respect to the FTE apportionment modifications, taxpayers with interests in unitary FTEs should review apportionment calculations for CIT returns. If the taxpayer owns less than 100% of one or more unitary FTEs, and there are sales between the taxpayer and the FTE and/or two FTEs unitary with the taxpayer, there may be modifications required to the sales factor. Inasmuch as this impact could be beneficial or detrimental to the taxpayer, a full analysis is recommended to determine the taxpayer's next steps.

For the other modifications provided in the so called "clean-up" bills, taxpayers should review the changes to determine if any of the modifications affect their apportionment factors or tax bases, or if, given the new definition of the term "officer," if the eligibility for claiming the small business credit has changed. Taxpayers that reported ITC recapture on their CIT returns should review their calculations with the new definitions and determine if any adjustments should be made. Additionally, for taxable years beginning after December 31, 2013, taxpayers with transactions between members of their UBG should review such transactions to determine if, given the new elimination provisions, any additional benefit may be available that may not have been claimed on previous CIT returns.

Even though these bills clarify or address various open CIT issues, at the same time, they also create some significant new technical issues, notably with the DISC exemption (as discussed above), for the adoption of the "section 381" mechanism for business loss deductions transferred to successor corporations, and for the ITC "tax benefit" mechanism. With respect to the section 381 successor mechanism, the new legislation does not discuss how much of a business loss deduction a taxpayer will succeed to, in the case where the target business being acquired is not the entire UBG. If the target that is acquired is only one member of a larger UBG that has a business loss deduction, it is not clear with this change how much, if any, of the loss will be transferred by the target to the acquirer. While the Michigan Department of Treasury ("Treasury") published an answer to a similar question on its Web site under "Frequently Asked Questions – Corporate

[9] In most cases, recapture was required if the taxpayer sells or otherwise moves the property out of Michigan less than five years after the year in which the credit was originally claimed. MCL §206.673(1).

Income Tax," this is merely Treasury's interpretation and has no statutory support, even after the above legislative change.[10]

With respect to the ITC recapture tax benefit mechanism, one significant technical issue that was left unaddressed relates to the ordering rule that should be used to determine how much ITC was "used" as compared to compensation credit for a taxpayer that was credit limited. These two credits were added together on the MBT return and then the credit limitation was applied, so many taxpayers had excess compensation credit and ITC, but the amount "used" did not distinguish between the two. As a simple example, if a taxpayer, due to having a significant compensation credit, had no change in MBT liability after removing the entire ITC, would the taxpayer be required to recapture any ITC?

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[10] As reported on Treasury's Web site:

> **Unitary Business Groups 11.** If a taxpayer that is a unitary business group has a business loss carry forward under MCL 206.623(4), what happens to the business loss carry forward if membership in the unitary business group changes?
>
> **Answer:** When the membership of a taxpayer that is a unitary business group changes, the business loss carryforward of the unitary business group is divided among the unitary business group and the departing members in proportion to the losses the members would have generated had each member filed separately. Specifically, the portion of the business loss carryforward of a taxpayer that is a unitary business group attributable to a departing member is an amount equal to the business loss carryforward of the unitary business group multiplied by a fraction, the numerator of which is what would have been the business loss of that member had that member filed a separate return, and the denominator of which is the sum of what would have been the separate business losses of all members of the group in that year having business losses if those members filed separate returns.