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Michigan replaces MBT with new corporate income tax

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On May 25, 2011, Michigan Governor Rick Snyder signed a three-bill tax package that replaces the Michigan Business Tax (MBT) with a 6 percent corporate income tax, effective January 1, 2012, and makes other changes. The MBT will be repealed except for taxpayers electing to claim "certificated" credits under the MBT until those credits are exhausted, with certain exceptions. In addition, the Governor approved a measure that bars taxpayers from apportioning income under the Multistate Tax Compact, effective January 1, 2011. [H.B. 4361, H.B. 4362, H.B. 4479, enacted 5/25/2011]

Notably, "taxpayer" under the new corporate income tax is limited to C corporations. Thus, sole-proprietorships and other flow-through entities that are subject to the MBT will not be subject to the corporate income tax. The new corporate income tax retains some of the features of the business income portion of the MBT: income tax would be apportioned under a single sales factor formula; sales of other than tangible personal property would be sourced to the state based on a market-based sourcing standard; a *Finnigan* sourcing rule would apply to unitary groups; and unitary groups would have to file combined returns. Like the MBT, nexus is established if the taxpayer has physical presence in the state for a period of more than one day during the tax year or if the taxpayer actively solicits sales in the state and has gross receipts of \$350,000 or more that are sourced to the state. Credits allowed under the MBT are not retained, with the exception of the "alternate tax credit" for taxpayers with gross receipts that do not exceed \$20 million and adjusted gross income that does not exceed \$1.3 million. Under H.B. 4362, the MBT repeal is effectuated by defining taxpayer under the MBT as "[t]hrough December 31, 2011, a person or a unitary



business group liable for tax, interest, penalty...." House Bill 4362 allows taxpayers to remain subject to the MBT if they wish to claim certain "certificated" credits.

The tax regimes currently in existence under the MBT for insurance companies and financial institutions will effectively be retained. The legislature used the MBT Act's language in the statutes and incorporated that into H.B. 4361. Thus, insurance companies will continue to be subject to the greater of a tax imposed at the rate of 1.25 percent of gross direct premiums written on property or risk located or residing in the state or the retaliatory tax. Insurance companies retain certain insurance-related credits. Financial institutions will be subject to tax based on net capital at a rate of 0.29 percent.

Note. Provisions of the new corporate income tax are imposed under H.B. 4361. Unless noted otherwise, "legislation" refers to H.B. 4361.

Taxpayers and nexus

The corporate income tax is imposed on every taxpayer, defined as a corporation, with "business activity" in the state or ownership interest in a flow-through entity that has business activity in the state, unless immune from tax pursuant to P.L. 86-272. Business activity means a transfer of legal or equitable title to or rental of property (real, personal, or mixed, tangible or intangible), the performance of services (or combination thereof), "made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others. but does not include the services rendered by an employee to his or her employer or services as a director of a corporation." The tax is also imposed on "foreign persons" as explained below. **Note.** Under the existing Michigan Business Tax, a taxpaver means an individual, firm, bank, financial institution, insurance company, limited partnership, limited liability partnership, co-partnership, partnership, joint venture, association, corporation, S corporation, limited liability company, receiver, estate, trust, any other group or combination of groups acting as a unit, and a unitary business group.

Substantial nexus is established if the taxpayer has physical presence in the state for a period of more than one day during the tax year, if the taxpayer "actively solicits" sales in the state and has gross receipts of \$350,000 or more that are sourced to the state, or of the taxpayer has an ownership interest or a beneficial interest in a flow-through entity (directly or indirectly through one or more other flow-through entities) that has substantial nexus in the state. 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; it 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 the state. The legislation directs the Department of Treasury to prospectively define "actively solicits."

Income tax base

The tax is imposed on a taxpayer's business income, which would be defined as federal taxable income, as modified. Federal taxable income means taxable income as defined under I.R.C. Sec. 63. The statute would adopt the I.R.C. as in effect on

January 1, 2012, or at the option of the taxpayer, in effect for the tax year. However, the statute decouples from Sections 168(k) and 199. In addition, the law requires that taxpayers add to federal taxable income:

- interest income and dividends from obligations or securities of states other than Michigan, in the same amount that was excluded from federal taxable income, less the related portion of expenses not deducted in computing federal taxable income because of I.R.C. Secs. 265 and 291;
- all taxes on or measured by net income (including this tax) to the extent deducted in computing federal taxable income;
- any carryback or carryover of a net operating loss to the extent deducted in computing federal taxable income; and
- any royalty, 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. (This addition has several safe-harbors.)

The law allows taxpayers to subtract:

- dividends and royalties received from persons other than U.S. persons and foreign operating entities, including but not limited to, amounts determined under I.R.C. Sec. 78 or Sections 951 to 964, to the extent included in federal taxable income;
- interest income from U.S. obligations, to the extent included in federal taxable income;
- any available business loss incurred after December 31, 2011. Business loss means a negative business income taxable amount after allocation and apportionment. The legislation would allow business losses to be carried forward for up to 10 years after the loss year.

The law requires the following to be eliminated from federal taxable income:

income from producing oil and gas, and expenses of producing oil and gas, to
the extent included in and deducted in arriving at federal taxable income,
respectively; this elimination is required if the oil and gas is subject to the
severance tax in Michigan.

Apportionment

Taxpayers with business activity that is taxable both in and out of the state would be required to utilize a single sales factor apportionment formula in apportioning the tax base. A taxpayer is deemed taxable in another state if either: (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 (b) the other state has jurisdiction to subject the taxpayer to one of the taxes described above, regardless of whether the other state subjects the taxpayer to the tax. The sales factor numerator is the total sales of the taxpayer in Michigan during the tax year; the denominator would be the total sales of the taxpayer everywhere during the tax year. The legislation adopts the Finnigan rule, meaning that, for a

unitary group, sales include sales in the state of every person included in the group, without regard to whether the group member itself has nexus with Michigan. Sales between unitary group members are eliminated from the sales factor. The legislation states that "[i]t is the intent of the Legislature" that each tax base is apportioned under the single sales factor "and that apportionment shall not be based on property, payroll or any other factor notwithstanding" the Multistate Tax Compact (MCL Sec. 205.581).

The legislation allows taxpayers to petition for, or allow the Department of Treasury to require, the use of an alternative apportionment formula if the standard formula would not fairly represent the taxpayer's business activity within the state. The petition may call for separate accounting, the inclusion of additional or alternative factors, or the use of any other method to effectuate an equitable allocation and apportionment.

The legislation provides extensive sourcing rules. Royalties and other income received for the use or privilege of using intangible property are attributed to the state in which the property is used by the purchaser. If the property is used in more than one state, the royalties or other income would be apportioned to Michigan based on that portion of the use that occurs in the state; if that portion cannot be determined, the amounts would be excluded from the sales factor altogether. Sales of services are attributable to Michigan if the recipient of the services receives all of the benefit of the services in the state. Where only a portion of the benefit of the services is in the state, receipts are attributed to Michigan to the extent the benefits are received in the state. Specific sourcing rules also apply to:

- receipts from the lease or rental of tangible personal property;
- receipts from the lease or rental of mobile transportation property;
- sales derived from securities brokerage services;
- receipts from loan origination or gains from the sale of a loans secured by instate realty;
- interest from loans;
- gains from the sale of loans not secured by realty;
- receipts from credit card receivables;
- receipts from the sale of credit cards or other receivables;
- loan servicing fees;
- receipts from the sale of securities and other assets from investment and trading activities;
- receipts from transportation services;
- receipts from telecommunications services, including mobile telecommunications services; and

programming and media receipts.

For a taxpayer that has an ownership or beneficial interest in a flow-through entity that has business activity in the state, the taxpayer's business income that is directly attributable to the business activity of the flow-through entity is apportioned to the state under the single-sales factor based on the activity of the flow-through entity.

All other receipts not otherwise sourced under the specific apportionment provisions are sourced based on where the benefit to the customer is received or, if the location where the benefit is received cannot be determined, to the customer's billing address.

Foreign persons

The legislation imposes the tax on a "foreign person," meaning "a person formed under the laws of a foreign country or a political subdivision of a foreign country, whether or not the person is subject to taxation under the internal revenue code." There is an exemption for foreign persons domiciled in a sub-national jurisdiction of a NAFTA country that does not impose an income tax on taxpayers domiciled in Michigan whose presence in the foreign country is the same as the foreign person's presence in the U.S.

Generally, the tax base of a foreign person is subject to all the adjustments and other provisions applicable to other taxpayers to the extent related to U.S. business activity. The tax base would not include proceeds from sales where title passes outside the U.S.

For a foreign person, "business income" means gross income attributable to the taxpayer's U.S. business activity and gross income derived from sources within the U.S. minus the deductions allowed under the I.R.C. that are related to that gross income. Gross income includes: (1) the proceeds from sales shipped or delivered to any purchaser within the U.S. and for which title transfers within the U.S.; (2) proceeds from services performed within the U.S.; and (3) a pro rata share of the proceeds from services performed both within and outside the U.S. to the extent the recipient receives benefit of the services within the U.S. The numerator of a foreign person's sales factor is the person's total sales in Michigan, where title passes inside the U.S., and the denominator is the person's total U.S. sales, where title passes inside the U.S. during the tax year.

Unitary groups

Under H.B. 4361, a unitary business group must file a combined return that includes each member that is a U.S. person and that is a C corporation under IRC Sections 1361(a)(2) and 7701(a)(3). Such members are treated as a single person and all intercompany transactions must be eliminated from the tax base and apportionment factors. A unitary business group means a group of U.S. persons, other than a foreign operating entity (defined in the statute), one of which owns or controls (directly or indirectly) more than 50 percent of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other U.S. persons, and that has business activities or operations that result in a flow of value between or among persons included in the group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. The business income of a unitary business group is the sum the business income of

each person, other than a foreign operating entity, a financial institution or a person subject to the tax on insurance companies, less any items of income and related deductions arising from transactions including dividends between persons included in the unitary business group.

Insurance companies and financial institutions

Insurance companies must pay a tax at the rate of 1.25 percent of gross direct premiums written on property or risk located or residing in the state. Excluded from direct premiums are premiums on policies not taken, returned premiums on canceled policies, receipts from the sale of annuities, and receipts on reinsurance premiums if the tax was paid on the original premiums.

In addition, the legislation imposes tax on every financial institution with nexus in the state at the rate of 0.29 percent of the institution's net capital. Net capital means equity capital (determined under GAAP) less the average daily book value of U.S. and Michigan obligations. The tax base is apportioned to the state under a single "gross business factor." A "financial institution" is a bank holding company, national bank, state chartered bank, an office of thrift supervision, a chartered bank or thrift institution, a savings and loan holding company, a federally chartered farm credit system institution, or an entity directly or indirectly owned by one of these entities, and a unitary business group of these entities. **Note.** These provisions are similar to the existing taxes on insurance companies and financial institutions.

Filing requirements

Calendar year filers must file quarterly returns and make estimated payments (25 percent of the estimated annual liability, with exceptions) on the 15th of April, July, October, and January. Other taxpayers must file quarterly and make estimated payments on the appropriate due date in the fiscal year that corresponds to the taxable year. For a taxpayer filing an estimated tax return for the taxpayer's first tax year of less than 12 months, each estimated payment must be proportional to the number of payments made in the first year.

Withholding requirements

Under H.B. 4361, every flow-through entity with business activity in the state that has more than \$200,000 of business income must, after allocation and apportionment, withhold an amount determined by multiplying the corporate income tax rate (6 percent) to the distributive share of the business income of each member that is a corporation or flow-through entity. Any member of such a withholding flow-through entity that is itself a flow-through entity must withhold in the same manner for each of its members, but the legislation allows for withholding taxes remitted at a lower tier flow through entity to be credited to upper tier flow through entities to alleviate duplicate withholding. Flow-through entities are still required to withhold on non-resident individuals and trusts.

Certificated MBT credits

Under H.B. 4362, taxpayers may elect to claim "certificated" credits currently allowed under the MBT if they continue to file MBT returns. "Certificated credits" include certain of the following credits: the early stage venture capital credit; brownfield

redevelopment credits; Michigan Economic Growth Authority ("MEGA") credits for photovoltaic technology, employment, anchor company payroll, federal government employment, anchor company taxable value, polycrystalline silicon manufacturing, high-power energy batteries, hybrid technology research and development; media production and infrastructure; historic preservation; renaissance zone; natural resources and environmental protection; and motorsports entertainment complexes.

Taxpayers that properly elect to remain subject to the MBT in order to claim a certificated credit for that year must continue to file under the MBT until the credit or carryforward is exhausted, in certain instances. The proposed statute's language differs slightly for taxpayers with a certificated brownfield or historic preservation credit. H.B. 4362 also provides that an electing taxpayer's MBT liability (after all credits, deductions, and exemptions) will be the greater of: the calculated MBT liability, after all credits, deductions, exemptions, and unused credit carryforwards, and the amount of the taxpayer's computed liability under the corporate income tax, less any certificated credits the taxpayer was allowed to claim under the MBT. This calculation excludes certain MBT business losses and nonrefundable credits.

MTC election

House Bill 4479 provides that "[e]xcept beginning January 1, 2011, any taxpayer subject to the Michigan Business Tax Act....or the Income Tax Act....shall for purposes of that Act, apportion and allocate with the provisions of that Act and shall not apportion or allocate in accordance with" the multistate tax compact.

PwC observes

"There are many parallels between this new corporate income tax and the MBT as it relates to the taxation of C corporations, notes Eric Burkheiser, PwC SALT Partner in Detroit. "The legislature has retained unitary reporting with the exclusion of foreign operating entities, single factor sales with market sourcing and tax rates have effectively remained the same."

"The new tax system relieves flow-through entities from the corporate income tax in Michigan; however, flow-through entities withholding obligations have increased, so these entities still have compliance obligations. It's unfortunate that the legislature did not allow companies to carryover MBT net operating losses to the new tax, and the new law does not allow for any provision to deal with the financial reporting implications that many companies will face by switching to this new tax regime," Burkheiser explains.

"As it relates to the financial reporting implications of the new tax, the Governor is expected to sign these bills very soon and before the June 30 quarter close for calendar year companies, so companies will need to spend time reviewing this new law and making appropriate changes in their financial statements. For taxpayers that elect to continue to pay the MBT, the financial accounting analysis will be strained because of the 'greater of' calculation, which requires a taxpayer to compare its MBT liability (after all credits) to its hypothetical corporate income tax liability (less certificated credits) and pay the greater of these amounts."

"By providing that 'beginning January 1, 2011' taxpayers shall not allocate or apportion in accordance with multistate tax compact, one may argue that the state has implicitly acknowledged the availability of the election for prior years. Furthermore, the legislature's change to the compact provisions could be challenged, with the possibility that taxpayers may be able to continue to file utilizing the MTC election," Burkheiser explains.

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