ATTORNEY DIRECTORY

535 Griswold, Suite 1900
Detroit, Michigan 48226
(313) 496-1200

255 E. Brown Street, Suite 320
Birmingham, Michigan 48009
(248) 645-9680

900 Victors Way, Suite 300
Ann Arbor, Michigan 48108
(734) 668-4100

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Special Edition
MICHIGAN BUSINESS TAX ALERT

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Special Edition
January 1, 2008 - Vol. 20, Issue 1

MICHIGAN BUSINESS TAX ALERT

By **George Runstadler, III**

On December 1, 2007, while Michigan taxpayers were analyzing the impact of the new Michigan Business Tax and the Sales Tax on Services, the legislature changed the Michigan Business Tax and repealed the Sales Tax on Services. This alert attempts to briefly summarize the current business tax situation in Michigan and provide suggestions on matters that may require immediate attention.

Sales Tax on Services

The Sales Tax on Services was in effect for one day. Anyone that collected any tax has the option of returning the tax to the customer or paying it to the state of Michigan by January 20, 2008. Penalties of up to 25% of the tax can be levied on those who retain collected Sales Tax on Services. Anyone that failed to collect the tax will receive amnesty.

Michigan Business Tax

The Michigan Business Tax ("MBT"), effective January 1, 2008, replaces the much maligned Single Business Tax. It has two components: The **Business Income Tax** will tax unitized and adjusted business income allocated to Michigan at 4.95%. In addition, the **Modified Gross Receipts Tax** will tax unitized and modified Gross Receipts allocated to Michigan at 0.8%. Small businesses may pay one alternate tax of 1.8% on Gross Receipts allocated to Michigan.

To replace the revenue lost by the repeal of the Sales Tax on Services, an MBT surcharge of 21.99% will be assessed on most taxpayers subject to the MBT. This increases the effective tax rates as follows:

Business Income Tax: from 4.95% to 6.038%

Modified Gross Receipts Tax: from 0.8% to 0.976%

Alternate Small Business Tax: from 1.8% to 2.196%

• "Adjusted Business Income" is that amount that would approximate federal taxable income from an MBT taxpayer irrespective of whether the taxpayer is a pass-through entity such as an S corporation, limited liability company, partnership, trust, or estate. However, self-employment income of owners may be deducted except to the extent attributed to return of capital.

• "Modified Gross Receipts" is gross receipts from a business subject to the tax less purchases of inventory, capital equipment subject to depreciation or amortization, and supplies. Also excluded are certain payments received as an agent for others.

• A small business eligible for the alternative rate of 1.8% (or 2.196% after surcharge) on gross receipts is a business with less than $18 million (phasing

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out to $20 million) in gross receipts, no officer receiving more than $160,000 (phasing out to $180,000) per annum compensation, and business income of less than $1.3 million.

Who Is Subject to the MBT?

All trade or business deemed operating in Michigan and selling or renting real estate or personal property, or rendering services, or a combination thereof, for gain is subject to the MBT. This would include individuals (except as an employee or director), limited liability companies, S corporations, trusts, and estates.

A significant "clarification" was included in the December 1, 2007 amendments to the tax act. Without this clarification, it was feared that many taxpayers would flee Michigan for more accommodating jurisdictions. Under the clarification, the MBT will **not** apply to investment transactions or sale of assets that had been put to a personal use, such as the sale of an individual's home or car. Investment transactions include gain on sales of investments, interest, and dividends. This exclusion would apply **only** to: (a) individuals; (b) estates; (c) partnerships organized exclusively for estate and gift planning purposes; and (d) trusts organized exclusively for estate and gift planning purposes. This exclusion does **not** apply to investment income from trusts or partnerships not created **exclusively** for estate and gift planning. The exemption does not apply to the sale or rental of property if the sale or rental of the property is an integral part of a taxpayer's regular trade or business. If interest, dividends, and gains are related to such regular trade or business, they are included as business income. Income from the sale of a business is also business income.

The tax is levied on all entities that provide goods or services in Michigan that are not exempt from federal tax. Financial institutions and insurance companies will have their own version of the MBT. If a unitary business group has Gross Receipts apportioned to Michigan that do not exceed $350,000, no tax is due. At $350,000 in apportioned Gross Receipts, an MBT return is not required. An MBT return is required if Gross Receipts are greater than $350,000, whether a tax is due or not. The tax is reduced proportionately when Gross Receipts range from $350,000 to $700,000, with the reduction eliminated at $700,000.

The MBT is designed to treat all related businesses in the United States as one taxpayer. This is the Unitary Business Concept. Related businesses are those businesses which meet two tests: 1) the ownership test where one person owns directly or indirectly more than 50% of each business and 2) value flows from one business to the other or the businesses are somehow integrated and interdependent. Income and Gross Receipts within each business and group are allocated to Michigan based on a single apportionment factor – sales with a destination or services rendered in Michigan. Sales with a destination outside the state of Michigan may be excluded from being deemed Michigan sales only if the sales are subject to tax in the other jurisdiction. Other apportionment methods may be used only with the approval of the Michigan Department of Treasury.

Michigan has enacted as broad a standard as possible to bring businesses outside of Michigan within the grasp of the MBT. Sales of over $350,000 a year from outstate with a Michigan destination are enough to subject the seller to the MBT. A salesperson's presence of more than one day in Michigan could impose the tax on the company represented.

Credits

A myriad of credits are available to reduce the MBT. The credits available for the superseded Michigan Single Business Tax remain available for the MBT. The principal new credits are as follows:

•0.296% of compensation paid in Michigan (reduced from the original tax act's 0.37%) for 2008 (limited to 50% of the MBT);

•2.32% of the cost of tangible assets, including fabrication and installation of depreciable assets placed in Michigan, (reduced from 2.9%) for 2008; and

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•1.52% of research and development expenses in Michigan (reduced from 1.9%) for 2008.

The total of these three credits cannot reduce the MBT by more than 65%.

•35% of personal property taxes levied after December 31, 2007 on most personal property. This credit is not available unless a personal property tax return is timely filed. A personal property tax return must be filed on or before February 20, 2008 and each following year to be eligible for the credit.

Direct Personal Property Tax Reduction

Part of Michigan's tax restructuring was a direct reduction in personal property taxes paid on commercial and industrial property. The reduction was 24 mils for personal property classified as industrial and 12 mils for commercial personal property. This approximates a reduction of 65% for industrial personal property and 23% for commercial personal property.

Tax Payment

The MBT is due in quarterly installments. For a calendar year taxpayer, installments are due April 15, July 15, October 15, and January 15. Each installment should equal 25% of at least 85% of the MBT liability for the year. The first installment is due April 15, 2008 and penalties are imposed for failure to comply. Reliance on the previous Michigan Single Business Tax will not be sufficient to avoid imposition of penalties for failure to comply.

What Should We Be Doing Now?

• Michigan has as broad a standard for subjecting businesses to the MBT as the state could legally enact. Some tax professionals feel it has gone beyond federally imposed limits. In addition, the Unitary Business Concept will group together and make taxable a number of business entities that would otherwise be exempt because of size. A review should be performed to see if the tax would be applicable under these new rules.

• The first installment of tax is due April 15, 2008 for all calendar year taxpayers. A good faith estimate of the tax should be calculated. Penalties will be imposed for failure to comply.

• The exemption for investment income for trusts and partnerships (including limited liability companies) applies only if the trust or partnership was created exclusively for estate and gift planning. Perhaps a reshuffling of the activities of trusts or partnerships should be considered to clarify that the purpose was exclusively for estate and gift planning.

• Personal property tax returns required by local assessors should be given heightened attention. Initially, they should be filed by February 20, 2008 to get the MBT credit. Further, the classification of the personal property becomes very important because of the increased reduction in millage afforded to industrial property as compared to commercial property.

• A reevaluation of the split between dividends and compensation for S corporation shareholders should be made in light of the Business Income Tax component of the MBT.

Conclusion

This alert cannot give a full explanation of the provisions of the Michigan Business Tax nor is it sufficient to ascertain the potential MBT liability of any single taxpayer. The exceptions and qualifications for each provision of the MBT are extensive and require review of a taxpayer's individual operations before any tax calculation can be relied upon.

The state of Michigan has established a website which conveys detailed information and includes a tax estimator. It is at http://michigan.gov/taxes. At the website, click on **Michigan Business Tax** at the left margin.

For more detailed guidance through this complicated web of new state taxes, contact a member of Berry Moorman's Tax Compliance Group.