

LEGAL ALERT

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GOVERNOR SIGNS LEGISLATION ESTABLISHING THE NEW MICHIGAN BUSINESS TAX

By Ann-Mary Petroskey

On July 12, 2007, Gov. Jennifer Granholm signed legislation that establishes the new Michigan Business Tax (“MBT”) as the replacement for the Single Business Tax (“SBT”), which expires at the end of the year. The new MBT uses a combination of taxes and incentives to collect the same amount of revenue—\$1.9 billion—as the expiring SBT. It also reduces personal property taxes by 65 percent for manufacturers and 23 percent for commercial businesses; gives small companies the option of paying a 1.8 percent tax on adjusted business income; and provides more than \$600 million in credits for research and investment.

The package of bills that created the tax—Senate Bill 94, and House Bills 4369-4372—are considered to be key to Michigan’s economic recovery and are intended to help the state attract jobs and job providers. The following is a brief summary of the major portions of the MBT.

Taxpayers Subject to the MBT

The MBT defines a “taxpayer” as a “person or a unitary business group liable for a tax” under the new 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.” Financial institutions and insurance companies are included in this definition, and are subject to industry-specific taxes.

Components of the MBT

The MBT has 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. Unitary business groups are required to file on a combined

basis for both types of taxes.

Income Tax

Income tax is imposed at the rate of 4.95 percent on business income after allocation and apportionment. It is imposed on every taxpayer with “business activity” within Michigan, unless prohibited by federal law. 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; and
- Carryback or carryover of a net operating loss, to the extent deducted for federal taxable income purposes.

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

- Dividends and royalties received from foreign persons;
- Income attributable to another entity whose business activities are taxable or would be subject to tax if business activities were in Michigan;
- 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;
- 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. It is imposed at the rate of 0.8 percent 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. Employee leasing or staffing companies are allowed a deduction for the compensation paid to personnel provided to their clients as well.

For the 2008 tax year, taxpayers will be allowed a deduction of 65 percent of any remaining Michigan SET business loss carryforward that was generated in either tax year 2006 or 2007.

Unitary Business Groups

The MBT requires combined filing for both taxes for "unitary business groups." Unitary business groups are determined based on an ownership test of more than 50 percent, where there is 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, but not foreign operating entities, financial institutions or insurance companies.

Apportionment

All multistate taxpayers will 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. It is unclear at this time 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 normal apportionment approach. The MBT also provides for special apportionment provisions for

several specific industries, including the transportation industry.

Credits

The MBT provides a number of tax credits. Some of these are new credits established under the MBT while others that existed under the Michigan SBT will continue to be available. The new tax credits include:

- *Compensation credit.* This credit is set at a rate of 0.37 percent and is allowed against wages paid to employees in Michigan. For a professional employer organization (PEO), the compensation credit available to the PEO will be not include the compensation payments made for employees provided to clients of the PEO; or the compensation paid by the PEO to the employees provided to the client company under the employee leasing arrangement, if the PEO manages the client's employment operations.
- *Investment tax credit.* This credit is 2.9 percent 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 percent of the taxpayer's total tax liability.
- *Research and development credit.* This credit is 1.9 percent of all research and development expenses in Michigan in the tax year. This credit, combined with the compensation and investment credits, cannot exceed 75 percent of the taxpayer's total tax liability. For the 2008-10 tax years, an additional R&D credit, limited to \$300,000, and under limited approval by the Michigan Economic Growth Authority, is available for equal to 30 percent of the amount of an "eligible contribution" made to certain small business engaged in R&D.
- *Filing threshold/phase-in credit.* For taxpayers who have gross receipts between \$350,000 and \$700,000, there is a phase-in credit 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. Businesses with gross receipts of less than \$350,000 are not required to pay taxes under the MBT.
- *Personal property tax credit.* This is a refundable credit of 35 percent of personal property taxes levied after December 31, 2007

on industrial personal property located on industrial real property. Similar credits are allowed for utility companies.

- *Entrepreneurial credit.* For tax years 2008-10 only, there is a credit of 100 percent of the increased tax liability attributable to the increase in employment. 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.
- *Arts/culture credit.* There is a nonrefundable credit for donations made to a municipal or nonprofit art, historical, or zoological institute. It is equal to half of the amount contributed above \$50,000 and is capped at \$100,000.
- The MBT also provides several business sectors with specific credits against the tax liability. These sectors include new motor vehicle dealers, certain grocery stores headquartered in Michigan, stadium owners, and the Michigan International Speedway. All of these credits are nonrefundable and may not be carried forward.

In addition to the new MBT credits, several tax credits that existed under the Michigan SBT have been extended to apply to the MBT, including the investment tax credit, the startup business credit, the Michigan early stage venture credit, the public contribution credit (now increased to \$10,000), workers' disability compensation credit, the community foundation contribution credit (now including donations to education foundations), the food bank and homeless shelter contribution credit, the Next Energy credit, MEGA credits, the Renaissance zone credit, the historic preservation credit, Brownfield credits, and the Hematite ore credit.

Small Business Provisions

Small businesses may be eligible for a reduced rate of 1.8 percent on "adjusted business income," provided they meet the following limitations:

- Business income must be less than \$1.3 million (increased from \$475,000)
- Officer compensation must be below the phase-out range of \$160,000-\$180,000 (increased from the SBT of \$95,000-\$ 115,000)
- Gross receipts must be below the phase-out

range of \$19 million - \$20 million (increased from \$9 million - \$10 million)

An entity meeting those requirements is allowed a small business credit to reduce its tax liability to an effective rate of 1.8 percent 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. Prior to the MBT, insurance companies were subject to a total tax of 1.0735 percent of adjusted receipts. Under the new law, insurance companies will be subject to a 1.25 percent tax on gross direct premiums written on property or risk located in Michigan. The MBT retains many industry-specific credits and contains a provision allowing the new compensation credit to insurance companies in certain situations.

Insurance companies will also now be subject to sales and use taxes, in addition to real and personal property taxes. 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. Unlike the SBT, the MBT does not include provisions allowing a company that has 90 percent of its assets and receipts from intangibles to be considered a financial institution.

Financial institutions will be subject to a 0.235 percent 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. For 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. Financial institutions that constitute a unitary business group are required to file a combined return.

Returns

Annual returns 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 filing 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 percent 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, however, 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 periods 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. 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.

Effective Date

The MBT is effective beginning on January 1, 2008. For taxpayers 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.

Revenue Sharing

The legislation places a limit on the amount of revenue the MBT can generate in fiscal years 2007-08, 2008-09 and 2009-10. If revenue exceeds the specified limit in any of these years, 50 percent 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.

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Personal Property Tax Relief

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

With the signing of the MBT, the taxing system on business entities in Michigan has been completely overhauled. These

new statutes will need to be reviewed to determine their impact on your business’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, several accounting principles may need to be considered for the first time.

SHRR tax attorneys can assist your company in determining the impact of the MBT. We will be monitoring how the MBT is implemented and potentially revised as corrections may be made to the legislation as it currently stands. With such a complete overhaul to the business tax structure, it is expected that currently unforeseen problems will arise, requiring amendments to those statutes. Our attorneys will be monitoring legislation and Michigan Department of Treasury communications on these matters to ensure that you have the most up-to-date information on this new tax structure.

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