

State and local tax trends
affecting businesses in 2008:

Looking back, looking ahead*
(update alert)

Businesses stay alert to MBT interpretation

In 2007, Michigan's state Legislature retired the Single Business Tax (SBT) and replaced it with the Michigan Business Tax (MBT), a two-pronged tax based on both gross receipts and business income. An article titled "Michigan's next bold experiment: From the SBT to the MBT," published in the PricewaterhouseCoopers State and Local Tax annual thought leadership journal: *State and Local Tax Trends Affecting Businesses in 2008: Looking Back, Looking Ahead* spells out the details of this transition. Since the adoption of the MBT, the state Legislature and the Department of Treasury have been amending and interpreting it. Given the enormity of the change—the complete abandonment of one tax system for another—taxpayers and tax advisors have eagerly awaited these amendments and interpretations, which will have a significant impact for businesses as they gear up to file their initial MBT returns for 2008.

MBT surcharge

Arguably, the most significant development affecting taxpayers since the MBT enactment is the imposition of an MBT surcharge of 21.99 percent for most taxpayers, imposed on the total tax calculated prior to the various credits under the act. The amount of the surcharge on financial institutions subject to the MBT based on net capital is 27.7 percent for tax years ending in 2008 and 23.4 percent thereafter. The surcharge is capped at \$6 million per taxpayer for any single tax year. Insurance companies are exempt from the surcharge. The surcharge was enacted on December 1, 2007, (Public Act 145) to replace a broad sales tax on services that was scheduled to take effect on that date.

FAS 109 deduction

On September 30, 2007, Gov. Jennifer Granholm signed legislation (Public Act 90) that allows taxpayers a deduction to offset the net deferred tax liability resulting from the imposition of the tax on business income and modified gross receipts under the MBT. If the book-tax difference results in a deferred liability for the first fiscal period ending on or after July 12, 2007, taxpayers would be allowed to deduct 4 percent of the difference for each qualifying asset for tax years 2015 through 2019, 6 percent of the difference for each qualifying asset for tax years 2020 through 2024, and 10 percent of the difference for each qualifying asset for tax years 2025 through 2029. The deduction cannot exceed the amount required to offset the taxpayer's net deferred tax liability computed in accordance with generally accepted accounting principles, which would otherwise result from the imposition of the MBT if the deduction were not allowed. A book-tax difference must be used only once in the calculation of the deduction arising from the taxpayer's business income tax base and modified gross receipts tax base. The deduction must be calculated without regard to the federal effect of such a deduction. If the adjustment is greater than the taxpayer's business income tax base, any unused adjustment may be carried forward indefinitely and applied as an adjustment to business income in later years. Book-tax difference is "the difference, if any, between the taxpayer's qualifying asset's net book value shown on the taxpayer's books and records for the first tax period ending on or after July 12, 2007, and the qualifying asset's tax basis on the same date." A "qualifying asset" means any asset shown on the taxpayer's books and records for the first fiscal period ending after July 12, 2007, in accordance with generally accepted accounting principles.

Economic nexus guidance

Another item of interest is the Department of Treasury's guidance regarding the expanded nexus standards that apply to the MBT. Under the MBT, nexus is established if a taxpayer is physically present in the state for more than one day during the tax year or, in the absence of a physical presence, if the taxpayer "actively solicits sales" in the state and has gross receipts of \$350,000 or more sourced to the state. The MBT statute does not define "actively solicit" but directed the department to draft written guidance to define the term. In Revenue Administrative Bulletin 2007-6, issued December 28, 2007, the department provided such guidance. Guided by other state court decisions that upheld economic nexus standards for taxes other than sales and use taxes, the department explained that active solicitation, coupled with the \$350,000 in gross receipts sourced to the state, constitutes a substantial economic presence standard. "Actively solicits" means the purposeful solicitation of persons within the state. "Solicitation is purposeful when it is directed at or intended to reach persons within Michigan or the Michigan market." Active solicitation includes but is not limited to: the use of mail, telephone and email; advertising, including print, radio, Internet, television and other media; and maintenance of an Internet site over or through which sales transactions occur with persons within Michigan. The department added that it will look to the quality, nature and magnitude of the activity when evaluating whether acts of solicitation are sufficient to establish active solicitation.

In July 2008, the department distributed for commentary proposed guidance regarding nexus being established if a taxpayer is physically present in the state for more than one day during the tax year. Under the draft guidance, a taxpayer has physical presence when, for a period of

two days or more during a tax year, the taxpayer or an employee, agent or independent contractor acting on behalf of the taxpayer in a representative capacity does any of the following:

1. Conducts business activity in the state including, but not limited to: performing services; selling, renting or leasing property; soliciting sales; making repairs, doing warranty work or providing maintenance or service to property that is sold or that is to be sold; collecting accounts related to sales of tangible personal property (through assignment or otherwise); installing or supervising installation; conducting training and seminars; providing technical assistance to customers; investigating, handling or assisting with customer complaints; providing consulting services; and soliciting, negotiating and entering into franchising or licensing agreements.
2. Owns, rents, leases, maintains or has the right to use and uses tangible personal property or real property in the state.
3. Delivers goods into the state in vehicles the taxpayer owns, rents, leases, uses or maintains.
4. Conducts the following activities in the state: meeting with in-state suppliers; meeting in-state with government representatives in their official capacities; attending occasional meetings; holding recruiting or hiring events; renting to or from an in-state entity customer list; or attending or participating at a trade show. This last point would mark a departure from the policy under the single business tax, under which these activities were presumed not to create nexus if not conducted for 10 days or more. The SBT also contained a trade show safe harbor that provided that trade show participation would not be considered solicitation regardless of frequency. The loss of these safe harbor protections could subject numerous taxpayers not previously subject to the SBT to the MBT.

Under the draft guidance, corporations incorporated or entities organized within Michigan have physical presence in the state. The guidance also provides that physical presence exists for one day when such presence is established for any portion of the day. Physical presence for more than one day exists when the presence of the taxpayer (or its employees, agents or independent contractors) extends beyond a single day or occurs in more than one day. The guidance also clarifies that the limitations of Public Law 86-272 apply to the imposition of the net income base of the MBT, but do not apply to the modified gross receipts base of the tax. Michigan Treasury has concluded that the modified gross receipts tax is not a net income tax subject to the limitations of PL 86-272.

Enacted MBT amendments

Just before the end of 2007, the state enacted several items targeted at specific industries. Under Public Act 205, for a taxpayer whose business activities include live radio or television programming, media receipts will be sourced to Michigan only if the commercial domicile or the customer is in Michigan and the customer and taxpayer have a direct connection or contractual relationship from which the receipts were derived. For media receipts from the sale of advertising, if the advertising customer is commercially based in Michigan and receives some of the benefit of the sale of that advertising in Michigan, the media receipts from that customer are included in the numerator of the apportionment factor used to determine MBT liability to the extent that the customer received the benefit of the advertising in Michigan.

Under Public Act 206, a credit is enacted for private equity funds in the amount of the fund's tax liability for the tax year (after claiming other credits) multiplied by a fraction: The numerator is the total activity of the private equity fund manager conducted in Michigan during the tax year, and the denominator is the total activity of the fund manager conducted everywhere during the tax year.

Public Act 207 extends the gross receipts deductions for repayments or redemptions of loans or similar marketable instruments to brokers and dealers or a person included in the unitary business group of a broker or dealer that buys and sells for its own account contracts that are subject to the Commodity Exchange Act. The legislation also provides, for purposes of the deduction, that such marketable instruments not be held as inventory. In addition, the legislation provides that inventory that is deductible from the modified gross receipts tax base as a "purchase from other firms" includes the cost of qualified securities and commodities, excluding interest expense other than interest expense related to repurchase agreements.

In 2008, Public Act 177 was enacted. It provides that construction contractors may deduct from the modified gross receipts base "payments for materials deducted as purchases in determining the cost of goods sold for the purpose of calculating total income on the taxpayer's federal income tax return." Although this provision ensures the deductibility of materials consumed by real estate contractors, it may have the effect of narrowing the deduction for "materials and supplies" available to all other taxpayers. This is because the amendment implies that materials not related to the production of inventory or the operation or maintenance of assets are not otherwise deductible under the MBT.

These enactments are just some of the MBT amendments; many more were enacted that relate to the various credits allowed under the tax.

Proposed MBT amendments

In February 2008, the Michigan Senate passed various measures that would provide additional exclusions from gross receipts, exclude qualified services of a partner from the definition of business activity and allow a unitary business group to include in the combined group a person not otherwise includable, provided ownership thresholds are met.

The most significant MBT bill passed by the Senate, Senate Bill 1038, would make several changes to the definition of gross receipts. For example, gross receipts would not include “those amounts that are only deemed received” under the Internal Revenue Code (IRC). In addition, the exclusion for proceeds from the sale or exchange of a property that is a capital asset would encompass proceeds from any hedging transaction under IRC Sec. 1221(A)(7). The exclusion for proceeds from a sale or other transaction involving land that is a capital asset would be amended to include land purchased before January 1, 2008. The legislation also excludes from gross receipts: interest income and dividends derived from US or Michigan obligations or securities in the same amount that was excluded from federal taxable income; dividends and royalties received from a foreign operating entity or a person other than a US citizen; any tax, fee or surcharge required by law; or any deposit required under the bottle deposit law; for a partner, amounts received that are attributable to

another entity whose business activities are taxable under the MBT or would be subject to the tax if the business activities were in Michigan; proceeds from the sale of depreciable property used in a trade or business that is fully depreciated under IRC Sec. 168; reimbursements of qualified costs for services provided to Medicaid recipients and beneficiaries; amounts paid to acquire and maintain insurance producers’ licenses; amounts paid for the lease of personal property if such lease is an integral part of the taxpayer’s regular business operations; and qualified payments to independent contractors by taxpayers licensed under Article 25 or 26 of the Michigan Occupational Code. A revised version of this bill was passed by the House on June 28, 2008, but was tie-barred to other controversial bills not supported by the Senate. The bill results in a revenue loss estimated at \$231 million for fiscal year 2008-09, and a replacement revenue source is deemed necessary to obtain the administration’s support for enactment.

Other bills passed by the Senate include Senate Bill 1009, which would exempt numerous foreign entities from the imposition of the tax and modify the calculation for other foreign taxpayers to provide significant relief from the tax. In addition, under Senate Bill 1053, a unitary business group may elect to include a person that would otherwise not be included in the group, provided the ownership threshold is met. Such election would be in effect for at least five years. Also, under Senate Bill 1054, business activity (income from which is the base of the business income portion of the tax) excludes services rendered by an individual partner to the partnership in which he or she is a partner. Although passed by the Senate, these bills and many other proposed changes to the MBT have not seen significant action, as the changes in SB 1038 are generally viewed as having the highest legislative priority.

Issues to watch

The effects of the MBT on taxpayers were discussed in detail in “Michigan’s next bold experiment: From the SBT to the MBT.” By virtue of the expanded nexus and combined reporting provisions, businesses that were not subject to the SBT may be subject to the MBT. In addition, as the MBT is considered to be an income tax for FAS 109 purposes, taxpayers need to monitor changes closely for any potential impact on deferred taxes.

In addition, several issues that the state has yet to address may have a significant impact on taxpayers. Two noteworthy issues include sourcing and unitary combined reporting.

- The MBT adopted a market-based sourcing mechanism for determining which sales are attributable to Michigan. However, the state has offered no guidance on how these sourcing provisions are to be implemented.
- The MBT also has adopted unitary combined reporting. The statute defines a unitary business group as a group of US persons, other than a foreign operating entity, 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 US 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 legislation provides that flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations. The state has provided only limited guidance on how these provisions are to be construed, and many unanswered questions exist. However, the state does assert that the ownership rules under IRC Sec. 318 apply in determining control, and that a mere “flow of funds” to or from a common owner will be considered sufficient to establish a unitary relationship.

Other items of interest that remain to be addressed include:

- The treatment of foreign entities;
- The administration and interpretation of the various new credit provisions;
- The constitutionality of the economic nexus standards, credits and other provisions;
- The potential enactment of additional input deductions for adversely affected industries
- Whether the surcharge remains in effect;
- Administrative issues including fiscal year return methods, differing year ends; and registration and filing protocols.
- Michigan taxpayers will need to stay alert as the state continues to amend and interpret this new tax.

Gregory Nowak of PricewaterhouseCoopers LLP is a Partner in the State and Local Tax practice based in Detroit, MI.

Adam Stuart Weinreb of PricewaterhouseCoopers LLP is a Director in the State and Local Tax practice based in New York, NY.

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