STEVEN E. GROB AND WAYNE D. ROBERTS

# Michigan Business Tax Update

## Significant Amendments Enacted as the New MBT Goes Into Effect

On 12/1/07, just hours after a new "services tax" became effective, the legislature repealed it and amended the MBT Act to make up for an estimated $750 million loss in expected services tax revenue.

Michigan tax developments continue at a furious pace. As detailed in our prior article in THE JOURNAL,[1] effective 1/1/08 Michigan repealed its former Single Business Tax (SBT) and replaced it with a new, multipart Michigan Business Tax (MBT). The MBT Act contains four separate taxes. Most taxpayers are subject to both the "Business Income Tax" (BIT), at the original rate of 4.95%, and the "Modified Gross Receipts Tax" (MGRT), at the original rate of 0.8%.[2] Financial institutions are subject to a special franchise tax at the original rate of 0.235% of apportioned net capital, and insurance companies are subject to a 1.25% tax on gross direct premiums.[3] Numerous tax credits are available.

Shortly after the enactment of the MBT, Michigan amended its Use Tax Act to expand the 6% use tax to 23 specified types of services (the "Services Tax").[4] The new Services Tax was drafted in a late-night weekend session of the legislature and was met with overwhelming criticism from nearly all fronts. In response to this criticism, on 12/1/07, just hours after the Services Tax became effective, the legislature repealed it with the passage of Public Act 145 of 2007 (P.A. 145).[5] In order to make up for the loss of an estimated $750 million per year in revenue that the Services Tax was expected to generate, the legislature also amended the MBT Act in several ways, most notably by adding a "surcharge" on the original MBT liability and by reducing certain significant credits. P.A. 145 also included several technical amendments to the MBT, as described below. Several other technical amendment bills were enacted, and it is anticipated that more will follow to further clarify or modify certain MBT Act provisions. The following discussion summarizes the amendments to the MBT Act contained in P.A. 145 and several other recent Acts, and also discusses several recent administrative pronouncements issued by the Michigan Department of Treasury interpreting the MBT Act.

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## Changes Contained in P.A. 145

The new legislation introduces an MBT surcharge, modifies various tax credits available under the MBT, and makes several technical corrections.

**MBT surcharge.** In addition to the taxes imposed under the MBT Act, and subject to certain limitations described below, each taxpayer subject to the MBT must now pay an annual surcharge equal to the following percentage of the taxpayer's MBT tax liability after allocation and apportionment to Michigan but before computing the various credits available under the MBT Act:

1. For taxpayers *other than financial institutions and insurance companies,* the surcharge is 21.99% (effectively raising the BIT rate from 4.95% to 6.0385% and the MGRT rate from 0.8% to 0.976%).
2. For financial institutions, the surcharge is (a) 27.7% (effectively raising the rate from 0.235% to 0.300095%) for tax years ending after 2007 and before 2009, and (b) 23.4% (effectively raising the rate from 0.235% to 0.28999%) for tax years ending after 2008. A financial institution that exercises only trust powers is not subject to the surcharge.
3. Insurance companies subject to the premiums tax are not subject to the surcharge.[6]

The following additional limitations apply to the surcharge.

- *Possible sunset.* If Michigan personal income growth exceeds 0% in any one of calendar years 2014, 2015, or 2016, the surcharges described above will not be imposed after 2016. "Michigan personal income" is personal income for Michigan as defined by the Bureau of Economic Analysis of the U.S. Department of Commerce or its successor.[7]
- *Surcharge cap.* The surcharge imposed on any non-financial institution taxpayer may not exceed $6 million for any single tax year.[8]
- *Certain small taxpayers excluded.* Taxpayers who qualify for the Small Business Alternative Credit are exempt from the surcharge.

A surcharge imposed is deemed part of the tax imposed under the MBT Act and will be administered, collected, and enforced as provided in that Act.[9] Estimated tax payments must be determined by including the surcharge.

**Reductions in available MBT tax credits.** P.A. 145 reduced the benefit of certain tax credits available under the MBT Act, in terms of the computation of the credits and the percentage of tax they can offset.

**Taxpayers who qualify for the Small Business Alternative Credit are exempt from the surcharge.**

**Compensation credit.** For the 2008 tax year, subject to the combined credit limitations (discussed below), a taxpayer may claim a credit against its MBT tax for 0.296% (previously 0.37%) of the taxpayer's compensation paid in Michigan. For tax year 2009 and later, the credit percentage reverts back to the original 0.37%.[10]

**Investment credit.** The investment tax credit (also subject to the combined credit limitations) was originally 2.9% of the cost of qualifying assets in Michigan. For the 2008 tax year, the rate has been reduced to 2.32%. The 2.9% rate again applies for 2009 and subsequent tax years.[11]

**Research and development credit.** The credit for R&D expenses in Michigan (also subject the combined credit limitations) was originally allowed at the rate of 1.9% of such qualifying expenses. For tax year 2008, the credit percentage is reduced to 1.52%. The original 1.9% rate applies to tax year 2009 and later.[12]

**Combined credit limitations.** In computing the total combined credits, two limitations apply:

1. For taxpayers other than insurance companies, for the 2008 tax year a taxpayer's total credits claimed for the compensation credit and the investment credit cannot exceed 50% (previously 65%) of its MBT tax liability before the imposition of the surcharge. For 2009 and subsequent tax years, the total compensation and investment credits cannot exceed 52% of the MBT tax liability before the surcharge.[13]
2. The cap on a taxpayer's combined compensation, investment, and R&D credits is reduced from 75% to 65% of the taxpayer's MBT liability before the surcharge.[14]

The tax surcharge may not be offset by the compensation, investment, and R&D credits.

**Miscellaneous technical amendments in P.A. 145.** Various technical changes affect investment activities, financial institutions, insurance companies, theater owners, motor vehicle dealers, tax rebate, and special credits.

**Taxation of investment activities.** One of the criticisms generated by the enactment of the MBT was its apparent applicability to investment activities conducted by individuals and various types of entities. In response, in P.A. 145 the legislature modified the definitions of "business income," which enters into the tax base for the BIT, and

"gross receipts," which enters into the computation of the MGRT, to provide limited exemptions from the imposition of the MBT.

*Business income.* In the case of: (1) an individual, (2) an estate, or (3) a partnership or a trust organized exclusively for estate or gift planning purposes (collectively the "excepted taxpayers"), "business income" is that part of federal taxable income derived from transactions, activities, and sources in the regular course of the taxpayer's trade or business, including the following:

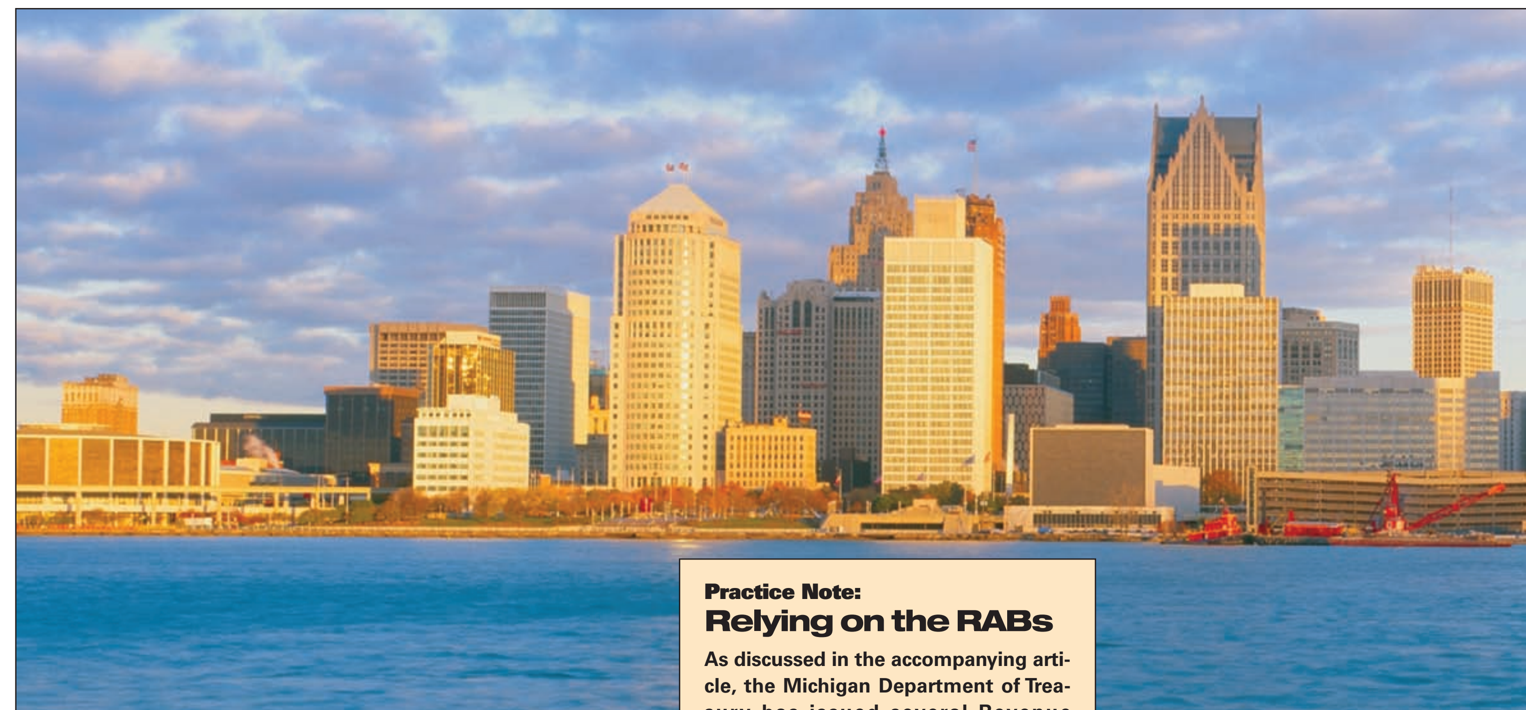
1. All income from tangible and intangible property if the acquisition, rental, management, or disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
2. Gains or losses incurred in the taxpayer's trade or business from stock and securities of any foreign or domestic corporation, and dividend and interest income.
3. Income derived from isolated sales, leases, assignment, licenses, divisions, or other infrequently occurring dispositions, transfers, or transactions involving property, if the property is or was used in the taxpayer's trade or business operation.
4. Income derived from the sale of a business.[15]

Activities generating income that is *not* included in business income for the "excepted taxpayers" include, but are not limited to, the following:

1. Personal investment activity, including interest, dividends, and gains from a personal investment portfolio or retirement account.
2. Disposition of tangible, intangible, or real property held for personal use and enjoyment, such as a personal residence or personal assets.[16]

*Gross receipts.* Similarly, for the "excepted taxpayers," "gross receipts" includes receipts from transactions, activities and sources in the regular course of a taxpayer's regular trade or business, including the following:

1. Receipts from tangible and intangible property if the acquisition, rental, management, or disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
2. Receipts in the course taxpayer's trade or business from stock and securities of any foreign or domestic corporation and dividend and interest income.
3. Receipts derived from isolated sales, leases, assignment, licenses, divisions, or other infrequently occurring dispositions, transfers, or transactions involving property, if the property is or was used in the taxpayer's trade or business operation.
4. Receipts derived from the sale of a business.[17]



Activities generating receipts *not* included in gross receipts for the "excepted taxpayers" include, but are not limited to, the following:

1. Personal investment activity, including interest, dividends, and gains from a personal investment portfolio or retirement account.
2. Disposition of tangible, intangible, or real property held for personal use and enjoyment, such as a personal residence or personal assets.[18]

Although the amendments to the definitions of "business income" and "gross receipts" were a step in the right direction, the actual statutory language leaves something to be desired. For a partnership or trust, it may be difficult to prove that the entity was organized *exclusively* for estate or gift planning purposes. Typically, some other purpose also exists for the use of such entities, such as more-efficient management of the assets or economies of scale resulting from pooling the assets. Also, this requirement may raise federal tax problems with respect to the need for a nontax purpose in order to satisfy the IRS that the entity is to be respected for federal tax purposes.

**Practice Note:**

**Relying on the RABs**

**As discussed in the accompanying article, the Michigan Department of Treasury has issued several Revenue Administrative Bulletins (RABs) interpreting the new Michigan Business Tax.**

**In accordance with Mich. Comp. Laws § 205.6a (enacted by 2006 P.A. No. 12, § 6a), a taxpayer may rely on an RAB issued by the Department after September 2006, and will not be penalized for that reliance unless and until the bulletin is revoked in writing. That reliance by the taxpayer is limited, however, to issues addressed in the bulletin for tax periods up to (1) the effective date of an amendment to the law upon which the bulletin is based or (2) the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based. (This same reliance applies also to letter rulings issued by the Department to a specific taxpayer on a specific tax matter related to a future transaction.)**

**Financial institutions.** In computing its franchise tax base, a financial institution may now deduct goodwill without the previous restriction that the goodwill had to arise "from purchase accounting adjustments for transactions that occurred after July 1, 2007." Also, the amendments clarify that the deduction for U.S. and Michigan obligations will be based on "average daily" book value.[19] Moreover, financial institutions are now allowed to claim a compensation credit.[20]

**Insurance companies.** An insurance company may now claim the compensation credit regardless of whether it takes any credits for payments made to Michigan associations.[21]

**Theater owners.** In computing their modified gross receipts tax base for the 2009 tax year, theater owners may now deduct 50% of film rental fees or royalties paid to a film distributor and/or film producer. The percentage increases to 100% for 2010 and subsequent tax years.[22]

**Motor vehicle dealers.** The motor vehicle inventory credit for a percentage of the dealer's payments to acquire new motor vehicle inventory is reduced from 2% to 0.25%. The annual $10,000 cap on the credit, however, is eliminated.[23]

**Tax rebate triggers.** The MBT Act provides for a refund to taxpayers if certain tax revenue thresholds are met for the state's "fiscal year" (October 1 through September 30). This provision, which was scheduled to sunset after three years, is now permanent. If MBT revenues exceed the formula base, 60% (previously 50%) is refunded and 40% is deposited into the budget stabilization fund. For fiscal year 2009 and later, refunds are available for only those taxpayers that claimed compensation, investment, and/or R&D tax credits during the immediately preceding fiscal year.[24]

**Special credits expanded.** The narrowly applicable credits allowed to a NASCAR speedway and a large food retailer have been expanded.[25]

## Changes in Other Recent Acts

In addition to P.A. 145, other legislation amended the MBT Act with regard to sourcing of media receipts, a private equity fund credit, the definition of inventory, and a hybrid car research and development compensation credit.

**Sourcing of media receipts.** Public Act 205 of 2007 amended § 305 of the MBT Act (dealing with sourcing of sales) to provide that for a taxpayer whose business activities include live radio or television programming, media receipts are sourced to Michigan only if the commercial domicile of the customer is in Michigan and the customer has a direct connection or relationship with the taxpayer pursuant to a contract under which the media receipts were received. With regard to the sale of advertising, if the customer is commercially domiciled in Michigan and receives some of the benefits of the sale of the advertising in Michigan, media receipts from such advertising are included in the numerator of the apportionment factor to the extent that the customer receives the benefit of the advertising in Michigan. For a broadcaster, the receipts from the sale of advertising are apportioned based on the ratio that the broadcaster's audience in Michigan bears to its audience everywhere.[26]

**Private equity fund credit.** Public Act 206 of 2007 added § 453 to the MBT Act, allowing a credit against the MBT for "private equity funds" (PEFs). For an "eligible taxpayer," the credit equals the

1 Grob and Roberts, "The Michigan Business Tax Replaces the State's Much-Vilified SBT," 17 JMT 8 (October 2007).

2 Mich. Comp. Laws § § 208.1201 (BIT), 208.1203 (MGRT).

3 Mich. Comp. Laws § § 208.1263 (financial institutions), 208.1235 (insurance companies).

4 H.B. 5198, 10/1/07 (2007 P.A. No. 93, effective 12/1/07).

5 H.B. 5408, 12/1/07.

6 Mich. Comp. Laws § 208.1281, as enacted by P.A. 145.

7 Mich. Comp. Laws § 208.1281(2), as enacted by P.A. 145.

8 Mich. Comp. Laws § 208.1281(3), as enacted by P.A. 145.

9 Mich. Comp. Laws § 208.1281(5), as enacted by P.A. 145.

10 Mich. Comp. Laws § 208.1403(2), as amended by P.A. 145.

11 Mich. Comp. Laws § 208.1403(3), as amended by P.A. 145.

12 Mich. Comp. Laws § 208.1405, as amended by P.A. 145.

13 Mich. Comp. Laws § 208.1403(1), as amended by P.A. 145.

14 Mich. Comp. Laws § 208.1405, as amended by P.A. 145.

15 Mich. Comp. Laws § 208.1105(2), as amended by P.A. 145.

16 Mich. Comp. Laws § 208.1105(2)(e), as added by P.A. 145.

17 Mich. Comp. Laws § 208.1111(1)(v), as added by P.A. 145.

18 *Id.*

19 Mich. Comp. Laws § 208.1265(1), as amended by P.A. 145.

20 Mich. Comp. Laws § 208.1403(2), as amended by P.A. 145.

21 Mich. Comp. Laws § 208.1239(2), as amended by P.A. 145.

22 Mich. Comp. Laws § 208.1113(6)(f), as added by P.A. 145 (defining "purchases from other firms," which are deductible under § 208.1203(3) in computing the MGRT base).

23 Mich. Comp. Laws § 208.1445(1), as amended by P.A. 145.

24 Mich. Comp. Laws § 208.1601, as amended by P.A. 145.

25 Mich. Comp. Laws § § 208.1409(2), as added by P.A. 145, and 208.1447(1), as amended by P.A. 145.

26 Mich. Comp. Laws § 208.1305(20), as added by H.B. 5460, 12/27/07 (2007 P.A. No. 205, effective 1/1/08).

27 Mich. Comp. Laws § 208.1453, as added by H.B. 5412, 12/27/07 (2007 P.A. No. 206, effective 1/1/08).

28 *Id.* These tax benefit provisions for "private investment"-type activity (and the "buys and sells for its own account" activity mentioned in the text accompanying note 29, *infra*) may be part of a national trend. See, e.g., Gotlinger and Mahon, "State Tax Exemptions for Investment Partnerships and Their Nonresident Partners," 17 JMT 22 (February 2008).

29 Mich. Comp. Laws § 208.1111(4)(d), as added by H.B. 5413, 12/27/07 (2007 P.A. No. 207, effective 1/1/08).

30 Mich. Comp. Laws § 208.1450, as added by S.B. 944, 12/27/07 (2007 P.A. No. 214, effective 1/1/08).

taxpayer's MBT liability attributable to its activities as a qualified PEF for the tax year (after claiming any other allowable credits) multiplied by a ratio based on the PEF manager's total activity conducted in Michigan during the tax year vs. the manager's total activity conducted everywhere during the tax year.[27]

An "eligible taxpayer" is a taxpayer that is a PEF that serves as a conduit for the investment of private securities not listed on a public exchange by accredited investors or qualified purchasers at any time during which the investment is acquired or subsequently used to claim the credit. A PEF "manager" is the person or persons responsible for the management of the investments of the eligible taxpayer. The location of the activity of the PEF manager is based on the location of the office from which the manager conducts management activity for the eligible taxpayer.[28]

**Definition of inventory.** Public Act 207 of 2007 amended § 111(4) of the MBT Act to expand the definition of "inventory" for a person that is a broker or dealer as defined under the Securities Exchange Act of 1934, or a person included in the unitary business group of that broker or dealer that buys and sells for its own account. Such inventory includes: (1) contracts that are subject to the federal Commodity Exchange Act, (2) the cost of "securities" as defined in IRC Section 475(c)(2) (a fairly general definition of "securities"), and (3) the cost of "commodities" as defined in IRC Sections 475(e)(2)(B), (C), and (D), excluding interest expense other than that related to repurchase agreements.[29]

**Hybrid car R&D compensation credit.** Public Act 214 of 2007 added § 450 to the MBT Act to allow a refundable credit against the MBT for tax years beginning after 2007 and ending before 2016 for a taxpayer engaged in research and development of a hybrid motor vehicle propulsion system, provided that before 4/1/07, the taxpayer had entered into an agreement with the Michigan Economic Growth Authority with regard to a "qualified facility" and the jobs to be performed there. The credit equals 3.9% of the compensation for services performed in the qualified facility that is paid to the employees at that facility in the tax year.[30]

The maximum credit that any one taxpayer can claim in a single tax year is $2 million. A "qualified facility" is a leased facility used for the research and development of the qualified technology and located in a city with a population between 80,000 and 82,000 and in a county with a population between 1 million and 1.3 million.[31] Obviously, this is a very focused credit intended for only one or two taxpayers who satisfy the requirements.

## Department of Treasury's Views on the MBT Act

The Michigan Department of Treasury has issued several administrative interpretations and explanations of the MBT Act, both in a "question-and-answer" format called "Frequently Asked Questions" (FAQs) and through the issuance of "Revenue Administrative Bulletins" (RABs).

**FAQs.** The following list summarizes, by topic, the approximately 75 FAQs issued by the Department as of 12/31/07.

- *Administrative matters* (21 FAQs), including estimated tax payments, return due dates, extensions, registration, forms, fiscal year filers.
- *Unitary issues* (10 FAQs), including apportionment, treatment of special purpose entities, flow of value, members in the group.
- *Apportionment issues* (3 FAQs), including definition of a "sale," treatment of rents, throwback.
- *Nexus* (2 FAQs), including nexus for a unitary group, nexus standards.
- *Business Income Tax* (6 FAQs), including taxation of S corporations and partnerships, self-employment income, compensation deductions, capital gains, deduction for book-to-tax differences.
- *Modified Gross Receipts Tax* (10 FAQs), including taxation of investors, rents, materials and supplies, business loss carryforwards, sales tax, elements of "purchases from other firms," capital gains.

- *Credits* (13 FAQs), including Renaissance Zones, professional employer organizations, small business credits, unitary groups, compensation, credit carryforwards, farmland preservation credit, credit recapture, rehabilitation credits.
- *Miscellaneous MBT topics* (10 FAQs), including taxation of foreign persons, distinction between professional employer organizations and staffing companies, sales tax as a gross receipt, limited liability companies, purchases from other firms.

These FAQs deal with a wide variety of both specific and general MBT issues. All FAQs are available on the Department's website (www.michigan.gov /treasury). The Department intends to address some of the more significant FAQ issues in subsequent RABs. The following discussion looks a little closer at one significant issue: unitary filings.

**FAQs regarding unitary filings.** Ten of the FAQs already released by the Department related to unitary filings. Under the MBT Act, a combined return is mandated for a "unitary business group" (UBG) (a significant variation from the Single Business Tax Act that the MBT replaced). The following is a brief summary of key points from the ten FAQs dealing with unitary groups:

1. Under the MBT Act, the tax base is apportioned using a single sales factor computed by dividing Michigan sales by everywhere sales. For a UBG, the sales of all members of the group are included in both the numerator and the denominator of the factor.
2. An out-of-state real estate investment trust (REIT) that has a Michigan subsidiary must file a consolidated return with its parent company to the extent that the two entities meet the definition of a UBG.
3. Apportionment for a UBG is not calculated separately for each member of the group, but rather on the combined tax bases of the group members.
4. Under the MBT, to the extent that it satisfies the filing threshold a "special purpose entity" (SPE) (including an SPE used to facilitate a securitization transaction) is a taxpayer. Alternatively, an SPE that satisfies the control and relationship tests under the Mich. Comp. Laws § 208.1117(6) definition of "unitary business group" may be a member of a UBG.
5. If a UBG includes both transportation companies and non-transportation companies, apportionment is done on a combined basis. First, receipts from transportation services are sourced according to Mich. Comp. Laws § § 208.1305(11) and (12). The transportation services receipts so sourced are then combined with other receipts or sales of the transportation company member and receipts or sales of other members of the UBG in both the numerator and the denominator to compute the group's sales factor. Although transportation services are subject to a specific sourcing rule, separate apportionment is not used for receipts from transportation services rendered by transportation companies included in a UBG with non-transportation members.
6. Two companies that have a flow of value between them but that are owned 50% each by two unrelated persons would not be considered a UBG. Under the control test in Mich. Comp. Laws § 208.1117(6), one of the members of the group of U.S. persons must own or control, directly or indirectly, more than 50% of the ownership interests (with voting or comparable rights) of the other U.S. persons. For this purpose, the Department will use as guidance the IRC Section 318 attribution rules for constructive ownership of stock or analogous authority to determine indirect ownership and control. The Department will apply the principles of Section 318 to all forms of entities subject to the MBT even though Section 318 pertains specifically to corporate stock ownership.
7. UBGs under the MBT Act are not the same as controlled or affiliated groups under the SBT Act. The SBT tests differ from those under the MBT. The MBT requires members of the UBG to meet a relationship test not found in the SBT. Therefore, while there might be some overlap between affiliated groups under the SBT and UBGs under the MBT, an SBT affiliated group will not necessarily be a UBG under the MBT. All facts and circumstances related to business activities and operations should be reviewed when determining whether a UBG exists.
8. Generally, a UBG is a group of related persons, including entities, whose business activities or operations are interdependent. A UBG is two or more persons that satisfy both a control test and one of two relationship tests under Mich. Comp. Laws § 208.1117(6):
   - The control test is satisfied when one person owns or controls, directly or indirectly, more than 50% of the ownership interests, with voting or comparable rights, of the other person or persons. Generally, indirect ownership is determined by applying the constructive stock ownership rules of IRC Section 318; the Department will apply those rules to all forms of ownership interests.
   - In addition to satisfying the control test, a unitary group must have business activities or operations that (a) result in a flow of value between or among persons in the group, or (b) are integrated with, are dependent upon, or contribute to each other. Flow of value is established when members of the group demonstrate one or more of the following: functional integration (e.g., common programs or systems and shared information or property), centralized management (e.g., common management or directors, shared staff functions, and business decisions made for the group rather than separately by each member), and economies of scale (e.g., centralized business functions and pooled ben-

efits or insurance). Groups that commonly exhibit a flow of value include vertically or horizontally integrated businesses, conglomerates, parent companies and their wholly owned subsidiaries, and entities in the same general line of business. Flow of value must be more than the mere flow of funds arising out of passive investment. Business are integrated with, are dependent upon, or contribute to each other under many of the same circumstances that establish flow of value. This alternate relationship test is commonly satisfied also when one entity finances the operations of another or when there are intercompany transactions, including financing.

9. Brother-sister corporations wholly owned by a single individual may be members of a UBG if they satisfy both the control test and one of the two relationship tests.
10. Where an individual owns 100% of a business and the individual's spouse owns 100% of another business, the entities may constitute a UBG. Under the constructive ownership of rules of IRC Section 318, each spouse is deemed to own the ownership interests of the other, and each business entity is deemed to own the ownership interests owned, directly or indirectly, by its owner. Therefore, the more-than-50% ownership test is met as each taxpayer business is deemed to own 100% of the other. If the two businesses have activities or operations that (a) result in a flow of value between them, or (b) are integrated with, are dependent upon, or contribute to each other, a UBG will exist.

**RABs.** To provide more formal guidance (including legal analyses) regarding its interpretation of certain aspects of the MBT Act, the Department has also issued Revenue Administrative Bulletins on the following matters:

**Final short-year SBT returns.** For fiscal year taxpayers, the 1/1/08 effective date for the repeal of the SBT and enactment of the MBT results in short-year tax filings in Michigan. RAB 2007-5, 12/28/07, provides guidance to fiscal year taxpayers with respect to their options for filing a final SBT return. Generally, such taxpayers have the option to use either (1) a short-year return cut off at 12/31/07 ("actual method"), or (2) a pro rata method ("annual method") that pro rates the tax liability determined on a 12-month fiscal year.

A taxpayer may claim SBT credits for its final SBT tax year only for credits earned and calculated based on actual payments made or accrued and actions performed from the end of its fiscal year in 2007 through 12/31/07. This "actual" method for credits must be used regardless of which general method is selected for filing the final SBT return (i.e., only actual credits generated prior to 2008 are allowed, even if the annual method, i.e., proration, is used to file the final SBT return). The method (actual or annual) chosen for the final SBT return must be used also for the first short-year MBT return. For a taxpayer with a fiscal year ending beyond 4/30/08 (the deadline for filing and payment of final 2007 SBT liability), the Department will grant an extension provided that substantially all of the estimated tax is paid with the extension request.

**Nexus; defining "actively solicits."** Under the MBT Act, a taxpayer that meets either of the following tests has substantial nexus with Michigan and is subject to the MBT:

- The taxpayer has a "physical presence" in Michigan for a period of more than one day during the tax year.
- The taxpayer "actively solicits" sales in Michigan and has gross receipts of at least $350,000 sourced to Michigan.[32]

31 *Id.*

32 Mich. Comp. Laws § 208.1200(1).

33 RAB 1998-1 was discussed in Grob, "New Nexus Standard Seeks to Broaden Michigan's Perception of Tax Jurisdiction," 9 JMT 14 (Mar/Apr 1999).

34 Mich. Comp. Laws § 208.1200(3).

35 To support its position that the bright-line physical-presence test set forth in Quill Corp. v. North Dakota, 504 U.S. 298 (1992), has been rejected in its application to taxes other than sales and use taxes, the Department cites West Virginia Tax Comm'r v. MBNA America Bank, N.A., 220 W.Va. 163, 640 S.E.2d 226 (2006), *cert. den.* FIA Card Services, N.A. (formerly MBNA) v. Tax Comm'r of the State of West Virginia, U.S.S.Ct. 6/18/07; Lanco, Inc. v. Director, Division of Tax'n, 188 N.J. 380, 908 A.2d 176 (2006), *cert. den.* U.S.S.Ct. 6/18/07; A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App., 2004), *rev. den.* N.C. S.Ct. 3/3/05, *cert. den.* U.S.S.Ct., 10/3/05. For more background on this area, see Eule and Richman, "Out-of-State Mail-Order Vendors Need Not Collect Use Taxes—Yet!," 2 JMT 163 (Sep/Oct 1992); and Nolan, "Crossing the Bright Line: Evaluating Physical Presence in *Quill*'s Shadow," 7 JMT 244 (Jan/Feb 1998). Both MBNA and Lanco were analyzed in Weiss, "*MBNA America Bank*: A New Standard for Nexus in Income and Franchise Taxation?," 17 JMT 8 (Mar/Apr 2007). Also see Sollie and Gutowski, "New Jersey: What Now for Intangible Holding Companies in the Wake of *Lanco*?," 15 JMT 18 (January 2006). For more on A&F Trademark, see Hannah and Hall, "North Carolina Enters the Delaware Intangible Holding Company Fracas," 11 JMT 6 (July 2001), discussing the North Carolina Secretary of Revenue's final decision in the matter (Dkt. No. 97-990, 9/19/00), which was ultimately affirmed by the state court of appeals.

36 Mich. Comp. Laws § 208.1201(1). P.L. 86-272 (the "Interstate Commerce Tax Act," 15 USC § § 381-384) limits a state's ability to assert income tax jurisdiction over a business whose only activity in the state is the solicitation of orders for sales of tangible personal property, provided the orders are sent out of the state for approval and are filled by shipment from outside the state. P.L. 86-272 does not protect other types of activities in a state and does not apply to non-income taxes (e.g., sales or use taxes) or to the sale of intangibles. See Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992), which was analyzed in Marcus and Lieberman, "Does *Wrigley* Clarify 'Solicitation' for Purposes of Taxing Interstate Commerce?," 2 JMT 148 (Sep/Oct 1992). See also Lieberman, "MTC Guidelines on P.L. 86-272 Implement the U.S. Supreme Court's Decision in *Wrigley*," 5 JMT 52 (May/Jun 1995).



The physical presence test is similar to the SBT nexus standard that was set forth in RAB 1998-1, 2/24/98.[33] A "physical presence" is 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. Physical presence 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.[34]

The MBT Act authorizes the Department to define the term "actively solicits"; it did so in RAB 2007-6, 12/28/07. This RAB reflects the Department's clear intent, for purposes of the MGRT, to impose the MBT using an economic-presence nexus standard.[35] The BIT portion of the MBT, by its own terms, is subject to the limitations of P.L. 86-272 such that the BIT cannot be imposed on a non-Michigan company whose only activities in Michigan are the solicitation of sales of tangible personal property.[36] This bifurcated nexus standard may create complexities for certain non-Michigan companies that solicit sales in Michigan because they now may be subject to the MGRT but not the BIT.

RAB 2007-6 includes the following broad language in the Department's interpretation of the term "actively solicits":

"Purposeful solicitation of persons within this state. Solicitation means (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order. 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, solicitation through (1) the use of mail, telephone, and e-mail; (2) advertising, including print, radio, internet, television, and other media; and (3) maintenance of an internet site over or through which sales transactions occur with persons within Michigan.

"Examples of active solicitation include sending mail order catalogs; sending credit applications; maintaining an internet site offering online shopping, services, or subscriptions; and soliciting through media advertising, including internet advertisements."

RAB 2007-6 states that whether a business "actively solicits" sales in Michigan will be determined based on facts and circumstances by considering the quality, nature, and magnitude of the activity of the business. The same standard used to determine nexus with Michigan, as described above, also will be used to determine whether a Michigan company has nexus with another state for purposes of MBT apportionment. Michigan companies must document their business activities in other states and retain records to sustain their right to apportion.

## Conclusion

The Michigan tax system for businesses has undergone a radical transformation, and significant interpretations of the new system are still in process. Even before the MBT's 1/1/08 effective date, the Michigan legislature substantially revised the MBT rates, credits, and other provisions. The Department of Treasury has recently issued a large quantity of administrative pronouncements on the MBT, and more are expected, along with the likelihood of several more technical correction bills by the legislature. ■

# Court Upholds Bank Shares Tax on Due Process Challenge (but DOR Drops an Exemption); Other Constitutional Issues Remain

In *Allfirst Bank v. Commonwealth,* 933 A.2d 75 (Pa., 2007), *aff'g* 895 A.2d 669 (Pa. Commw., 2006), the Pennsylvania Supreme Court upheld the constitutionality of the Pennsylvania bank shares tax with respect to banks with non-Pennsylvania shareholders. (This means, typically, a bank owned by a bank holding company that does not have Pennsylvania nexus.) The bank shares tax is an annual tax imposed by the state on the taxable value of shares of stock issued by a bank. Banks doing business in Pennsylvania must report and pay this tax but they are not subject to the state's corporation net income tax or franchise tax.

**In-state bank had out-of-state ownership.** Allfirst Bank was a wholly owned subsidiary of First Maryland Bancorp (FMB) until September 1999, when FMB merged with and into Allfirst Financial, Inc. (AFI). FMB and AFI were incorporated in Maryland and Delaware, respectively, and, at all relevant times, maintained a primary place of business in Baltimore, Maryland. Neither of these bank holding companies conducted business in Pennsylvania at any time relevant to this litigation. The tax periods at issue were 1999 and 2000 (the bank shares tax is assessed as of January 1 of each year). *(Continued on page 48)*

## Corporate Franchise and Income Taxes

*(Continued from page 23)* Following a review of Allfirst's tax reports, the Department of Revenue required the bank to pay an additional $10 million in bank shares taxes. Allfirst appealed to the Board of Finance and Revenue, arguing, among other things, that it, as a corporation, is not subject to the bank shares tax, and that the tax is instead levied upon its shareholder, a bank holding company with no Pennsylvania nexus. The Board rejected this argument and affirmed the Department's resettlements of the bank's tax reports. On further appeal, a divided en banc panel of the Commonwealth Court affirmed the Board's orders.

**High court agrees, noting that "banks," as entities, are required to pay the tax.** According to the supreme court, the issue in the case concerned whether Pennsylvania's bank shares tax is levied against the financial institution itself, or is instead a personal property tax imposed on the institution's shareholders. Allfirst Bank challenged the constitutionality of the tax, arguing that because it is measured by the value of a bank's shares, it was a tax on the property of Allfirst's out-of-state shareholder. Allfirst further contended that because its sole shareholder was a bank holding company with no Pennsylvania nexus, the application of the tax to Allfirst's shares constituted a violation of the Constitution's Due Process Clause. To support its argument that the tax was imposed on its shareholder, Allfirst relied on the language of the statute (72 Pa. Stat. Ann. § 7701) that gave the bank the right to pay the tax "either from its general fund, or from the amount of said tax collected from its shareholders....", as well as on decisions in cases arising under prior versions of the bank shares tax that had interpreted the tax as being imposed on a bank's shareholders.

The supreme court rejected Allfirst's arguments. In concluding that the tax was imposed on banks as entities, and not on their shareholders, the court relied on the statutory language that imposed the primary reporting and payment obligations on the bank itself. Although a bank was authorized to collect the tax from its shareholders, the bank nevertheless had no recourse against the shareholders in the event of nonpayment of tax.

**Good news/bad news.** Although this decision is not good news for the many banks that had pending refund claims based on the constitutional argument raised by Allfirst, it is not necessarily unwelcome news for all banks. Had Allfirst prevailed, that outcome would have had no effect on the imposition of the shares tax on banks owned by holding companies with Pennsylvania nexus. In addition, as noted above, only those banks subject to the shares tax are exempt from the Pennsylvania corporate net income tax and franchise tax for years beginning after 2000. Thus, if Allfirst had prevailed, banks owned by out-of-state holding companies would have faced liability for corporate net income tax and franchise tax for all those years. For many banks, the potential liability for those Pennsylvania corporate taxes would have exceeded any bank shares tax savings that would have resulted from an Allfirst victory.

**Loss of an exemption.** The Pennsylvania Department of Revenue has used the decision in *Allfirst* to eliminate an exemption that applied under the bank shares tax. According to the Department, pursuant to this decision "there is no basis for an exemption from bank shares tax based upon the identity of the shareholder. Accordingly, financial institutions are no longer permitted to reduce the taxable amount of shares by the value attributed to shares held by charitable, religious or educational institutions." This change is effective for the calculation of the bank shares tax for 1/1/08 and thereafter. (See Pa. Corp. Tax Bulletin No. 2007-02, 11/28/2007.) It is unclear whether this exemption has much real impact, however, since shares of most major banks are owned by bank or financial holding companies.

**More to come?** Though the shares tax has overcome the Allfirst attack, it remains a target. Several other constitutional challenges have been raised by other taxpayers.

For example, in a case currently pending before the Commonwealth Court, Lebanon Valley Farmers Bank argues that, with respect to two Pennsylvania banks that merge, the method of computing the shares tax violates the Uniformity Clause of the Pennsylvania Constitution. The taxpayer contends that the tax treats a merger of two in-state banks different from the merger of an in-state bank with an out-of-state bank. This latter result was confirmed by the holding in *First Union National Bank v. Commonwealth,* 885 A.2d 112 (Pa. Commw., 2005), *aff'd* 587 Pa. 507, 901 A.2d 981 (2006). In that case, the courts confirmed that, according to the statute, a bank that survives a merger with an out-of-state bank may exclude the value of the out-of-state bank from the shares tax base. Lebanon Valley is arguing for the same treatment for in-state mergers.

Another constitutional issue that has been raised with respect to the bank shares tax is whether the inclusion of historical values of previously unrelated banks in the shares tax base results in the taxation of non-unitary values by Pennsylvania in violation of the Commerce Clause requirement of fair apportionment. For instance, in *First Union,* the taxpayer argued that when one bank acquires and merges with another bank, the values of the two banks cannot be combined for any year during the six-year measurement period in which the banks were not unitary. The Commonwealth Court never needed to reach that argument in *First Union* because it resolved the case on statutory grounds, but it nonetheless reacted favorably to the argument in a footnote in the decision. We expect that banks with Pennsylvania nexus (and, thus, not covered by the decision in *First Union*) that merge may raise this argument to exclude pre-merger value.

Finally, in another case pending before the Commonwealth Court, PNC Bank has raised a different issue—whether the inclusion of Federal Home Loan Bank stock in the shares tax base constitutes a violation of the constitutional immunity from state taxation enjoyed by federal obligations.

Therefore, the *Allfirst* decision is not the end of the story. With several constitutional issues still unresolved, we expect the bank shares tax to continue to be the focus of controversy for the foreseeable future. ■

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