

Taxation of Financial Institutions Under the New Michigan Business Tax

The new tax imposes a tax on financial *institutions* very different from that paid by financial *organizations* under the prior regime.

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Effective January 1, 2008, businesses with nexus in Michigan are subject to the Michigan Business Tax (the “MBT”). On December 31, 2007, a voter-initiated repeal of Michigan’s prior tax, the Michigan Single Business Tax (the “SBT”) became effective.

OVERVIEW OF THE NEW TAX

Michigan’s new MBT is a single tax act that contains four separate taxes. The taxes and rates [prior to considering subsequently enacted surcharges discussed infra] are as follows:

- 4.95% business income tax;¹
- 0.8% modified gross receipts tax;²
- .235% franchise tax on financial institutions;³ and
- 1.25% premiums tax on insurance companies.⁴

For taxpayers other than financial institutions and insurance companies, the MBT liability consists of the sum of the tax imposed on the net income of the business (the “Business Income Tax” or “BIT”)⁵ and the tax imposed on the modified gross receipts

of the business (the “Modified Gross Receipts Tax” or “MGRT”).⁶ In contrast, financial institutions and insurance companies are exempt from both the BIT and the MGRT, and instead are subject to special taxes. This article explores the special MBT franchise tax imposed on financial institutions and compares this new tax to the prior SBT as it applied to financial organizations.

MBT TAX ON FINANCIAL INSTITUTIONS

Financial institutions with nexus in Michigan⁷ (based on the MGRT’s broad nexus standard, discussed below) are subject to a franchise tax on its allocated or apportioned Michigan tax base, at a rate of 0.235%. As indicated above, financial institutions are exempt from the other generally applicable taxes imposed under the MBT; financial institutions are subject only to this financial institution franchise tax.

Definition of a “Financial Institution” Under the MBT.

The threshold question in evaluating the MBT is whether the taxpayer is a financial institution. The MBT financial institutions tax applies only to an organization that meets the MBT definition of a “financial institution.” Under the MBT definition, a “financial institution” is:

- (i) A bank holding company, a national bank, a state chartered bank, an office of thrift supervision chartered bank or thrift institution, or a savings

¹ MCL 208.1201.

² MCL 208.1203

³ MCL 208.1263.

⁴ MCL 208.1235.

⁵ MCL 208.1201.

⁶ MCL 208.1203.

⁷ Nexus is determined under MCL 208.200.

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- and loan holding company other than a diversified savings and loan holding company. . . . [or]
- (ii) Any person [who is not subject to the MBT insurance company tax (discussed *infra*)] who is directly or indirectly owned by an entity described in subparagraph (i) and is a member of the unitary business group. . . . [or]
 - (iii) A unitary business group of entities described in subparagraph (i) or (ii), or both.⁸

The test to determine whether an entity is a “financial institution” under the MBT is an organizational test rather than a test based solely on business activity or operations. This type of organizational classification is significantly different from the type of classification used under Michigan’s prior SBT Act. Under the SBT Act, the definition of a “financial organization” indicated that a financial organization was:

[A] bank, industrial bank, trust company, building and loan or savings and loan association, bank holding company as defined in 12 U.S.C. 1841, credit union, safety and collateral deposit company, regulated investment company as defined in the internal revenue code, and any other association, joint stock company, or corporation at least 90% of whose assets consist of intangible personal property [“90% Asset Test”] and at least 90% of whose gross income consists of dividends or interest or other charges resulting from the use of money or credit [“90% Income Test”] [collectively, the “90/90 Test”].⁹

The SBT Act, therefore, defined a “financial organization” based on the entity’s organization, charter, or designation, or based on whether the entity’s operations and asset structures satisfied a statutory 90/90 Test. The latter part of the definition focused solely on an operational test. This allowed many types of business taxpayers that would not generally be thought of as financial institutions to be classified as a financial organization during a tax year, depending upon the nature of their assets and income. For example, a corporation engaged in a finance-related business might, on an annual basis, be classified as a financial organization or a regular SBT taxpayer depending upon whether it met the statutory 90/90 Test. The determination of whether an entity was a financial organization for SBT purposes was made on an annual basis. With some planning, a finance company often could choose whether it would be characterized as a regular taxpayer or a financial organization by, for example, structuring its assets

such that more or less than 10% were not intangible personal property.

Under the MBT, there are no operational tests. There are no asset or income tests included in the definition of financial institution and the term “financial organization” has been abandoned in favor of the more limited “financial institution” terminology. Thus, under the MBT, whether an entity is a “financial institution” is based upon the manner in which the entity is organized, chartered and regulated. Although an entity’s organizational characteristics theoretically could change from year to year, in practice such orga-

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nizational characteristics are unlikely to be changed as a tax planning technique.

Financial Institution Classification and MBT Unitary Business Group Issues. The MBT is imposed on a unitary basis.¹⁰ Therefore, if a financial institution is a member of a unitary business group, the financial institution’s unitary group is the MBT taxpayer and must file a combined MBT return. The MBT definition of “financial institution” specifically indicates that a member of a financial institution’s unitary group includes any person, other than an insurance company, that is directly or indirectly owned by a financial institution and is a member of the unitary business group.¹¹ Therefore, if a parent organization in a unitary group is classified as a financial institution, the parent’s entire unitary business group is classified as a financial institution. Based on this provision, a financial institution’s unitary business group can include other types of entities or persons that would not independently qualify as financial institutions. For example, a bank and its non-financial institution equipment leasing subsidiary may be a financial institution unitary taxpayer. In this example, the equipment leasing subsidiary may not independently qualify as a financial institution, but if the parent bank and the subsidiary constituted a unitary business group they would be treated as a single financial

⁸ MCL 208.1261(f).

⁹ MCL 208.10(4).

¹⁰ MCL 208.1117(5) & (6).

¹¹ MCL 208.1261(f)(ii).

institution taxpayer and required to file a combined financial institution MBT return.

The MBT's franchise tax on financial institutions represents a radical change in the approach to taxing financial institutions in Michigan, and presents a tax that is very different from the prior SBT. In general, under the SBT each "financial organization" with business activity in Michigan was subject to the SBT on a separate basis.¹² Moreover, determining whether a given taxpayer was a "financial organization"

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subject to the SBT financial organization tax was determined based on a broad definition that included both organizational and operational tests (including the 90/90 Test).¹³

MBT Tax Base for a Financial Institution. The tax base for a financial institution is its apportioned net capital: under the MBT, net capital is equity capital as computed in accordance with United States generally accepted accounting principles ("GAAP"), reduced by goodwill and the average daily book value of United States obligations and Michigan obligations.¹⁴ Net capital does not include up to 125% of the minimum regulatory capitalization requirements of an insurance company subject to the MBT premiums tax.¹⁵

Under the MBT, net capital is determined based on a five year net capital average.¹⁶ For a financial institution that has not been in existence for a period of five tax years, net capital shall be determined by adding together the financial institution's net capital for the number of tax years the financial institution has been in existence and dividing the resulting sum

by the number of years the financial institution has been in existence.¹⁷

If a financial organization engages in certain types of reorganizations,¹⁸ the post-reorganization entity is treated as if it were a single entity in existence for the entire tax year of the change, and for each subsequent tax year.¹⁹ Similarly, a combination of two or more financial institutions is treated as if the constituent financial institutions had been a single financial institution in existence for the entire tax year in which the combination occurred and in each tax year after the combination.²⁰ A "combination" for this purpose includes any acquisition required to be accounted for by the surviving financial institution in accordance with GAAP or a statutory merger or consolidation.²¹

The MBT "Temporary" Surcharge. A "temporary" MBT surcharge was enacted as part of Public Act 145 of 2007 ("PA 145"). PA 145 repealed a short-lived and highly unpopular expansion of the Michigan use tax on services. This surcharge has the economic effect of increasing the effective MBT rates. The surcharge rates were calculated such that the total surcharges would be adequate to replace the projected tax revenue that the repealed services tax would have raised.²²

Interestingly, the provisions of PA 145 do not directly increase the MBT rates. Instead, the increase is imposed through what have been classified as "temporary" surcharges on the total tax liabilities as calculated using the standard rates. A taxpayer first calculates its total MBT liability, and then adds to that liability the product of the surcharge and the original MBT liability. The surcharges for financial institutions apply as follows:

1. For tax years ending after December 31, 2007 and before January 1, 2009, the MBT surcharge is 27.7% (effectively raising the tax rate to 0.300095%).²³

¹⁷ Id. (a partial year is treated as a full year in the averaging calculation).

¹⁸ Including a reorganization under Section 1361(a)(1)(F) of the Internal Revenue Code of 1986, as amended, that is a mere change in identity, form or place of organization.

¹⁹ MCL 208.1265(3)(a).

²⁰ MCL 208.1265(3)(b) (the book values and deductions for United States obligations and Michigan obligations of the constituent institutions are combined).

²¹ MCL 208.1265(3)(b).

²² The expansion of the Michigan use tax to specific services was enacted as 2007 Mich. Pub. Act 93 (which Act was repealed on December 1, 2007, the date it was to become effective).

²³ MCL 208.1281(1)(b)(i).

¹² MCL 208.6(1).

¹³ MCL 208.10(4).

¹⁴ MCL 208.1265(1) (If the financial institution does not maintain its books and records in accordance with generally accepted accounting principles, net capital shall be computed in accordance with the books and records used by the financial institution, so long as the method fairly reflects the financial institution's net capital for purposes of the tax levied by this chapter).

¹⁵ Id.

¹⁶ MCL 208.1265(2).

2. For tax years ending after December 31, 2008, the MBT surcharge is 23.4% (effectively raising the tax rate to 0.28999%).²⁴
3. A financial institution that exercises only trust powers is not subject to the surcharge.²⁵

The surcharges are classified as temporary based on a portion of the statute providing that the surcharge will not apply after 2016 if Michigan personal income growth exceeds 0% in 2014, 2015, or 2016.

MBT Apportionment. A financial institution with business activity both within and outside Michigan must apportion its tax base by multiplying the tax base by a “gross business factor.”²⁶ The gross business factor is made up of the following fraction:

$$\frac{\text{(total gross business of the financial institution in Michigan during the tax year)}}{\text{(total gross business of the financial institution everywhere during the tax year)}}^{27}$$

Under the MBT, “gross business” is defined as the sum of the following:

- (i) Fees, commissions, or other compensation for financial services.
- (ii) Net gains, not less than zero, from the sale of loans and other intangibles.
- (iii) Net gains, not less than zero, from trading in stocks, bonds, or other securities.
- (iv) Interest charged to customers for carrying debit balances of margin accounts.
- (v) Interest and dividends received.
- (vi) Any other gross proceeds resulting from the operation as a financial institution.²⁸

To arrive at gross business of a unitary group, the sum of the above gross business amounts is then reduced by amounts attributable to transactions between or among any entities included in the financial institution’s unitary business group.

In computing the gross business factor, financial institutions must carefully determine whether certain types of income must be sourced to Michigan. The MBT contains detailed and specific sourcing rules for different types of financial institution income.²⁹

²⁴ MCL 208.1281(1)(b)(ii).

²⁵ MCL 208.1281(4)(b).

²⁶ MCL 208.1267(1).

²⁷ MCL 208.1267(3).

²⁸ MCL 208.1261(g).

²⁹ MCL 208.1269 (the detailed apportionment sourcing provisions are beyond the scope of this article).

COMPARISON WITH TAXATION OF FINANCIAL ORGANIZATIONS UNDER THE SBT

In general, financial organizations were subject to the SBT in the same manner as other business taxpayers.³⁰ There was no separate SBT tax applicable to financial organizations and financial organizations paid SBT based on their theoretical “value added.” However, in determining the tax base for a financial organization, there were certain financial organization-specific adjustments.

For a financial organization, interest income included in federal taxable income was not a subtraction (except for interest from United States Obligations) in arriving at the SBT tax base. As a parallel, interest expense deducted in determining federal taxable income was not an addition in arriving at the SBT tax base.³¹ These differences reflect the fact that net interest income is a part of the “value added” by a financial organization.

MBT NEXUS: FINANCIAL INSTITUTIONS SUBJECT TO THE MBT

For non-Michigan financial institutions, one of the most notable differences between the SBT and the MBT is Michigan’s new nexus standard. The MBT adopts a dual nexus standard that includes both a physical presence test and an economic presence test. For many years, many non-Michigan financial institutions have made loans secured by Michigan real and personal property. For these types of lenders, generally, there would have been no SBT filing requirement as long as the lender had no further activity or connection with Michigan. For 2008 and future years, the MBT’s new nexus standard may have created new tax burdens for many of these non-Michigan financial institutions.

Nexus Standard Applicable to Financial Organizations Under Michigan’s Prior SBT. As indicated above, under the SBT effective through December 31, 2007, every financial organization with “business activity” in Michigan was subject to the SBT.³² The Treasury Department’s administrative position regarding SBT nexus was set forth in Revenue Administrative Bulletin (“RAB”) 1998-1.³³ The RAB 1998-1 nexus standard was relatively broad. However, with respect to financial organizations that made loans secured by Michigan property, the Department took the administrative position that neither agents nor lenders

³⁰ MCL 208.6(1).

³¹ MCL 208.21(1).

³² MCL 208.6(1).

³³ RAB 1998-1.

were subject to the SBT solely by reason of making loans that were secured by Michigan collateral. This longstanding policy of the Department had been expressed in published “Questions and Answers.”³⁴ In its relevant “Question and Answer” on financial organization nexus, the Department advised that there is not sufficient nexus to impose the SBT on a nonresident financial organization whose only activity in Michigan is making loans secured by property located in Michigan, unless the financial organization operates property on which it has foreclosed.³⁵ Therefore, under the Department’s applicable policy statements, generally, financial organizations were not subject to the SBT solely due to making loans secured by Michigan property—provided that they did not take over possession, ownership, operation, control or management of the collateral property (or in any other way create a nexus with Michigan). Although the Department may have been able to change its administrative policy on this point under the broad SBT nexus standards set forth in RAB 1998-1, the Department never made such a change.

Nexus Standard Applicable to Financial Institutions Under Michigan’s New MBT. The MBT re-opened the Department’s consideration of nexus for non-Michigan financial institutions. The MBT Act adopts a new “substantial nexus” standard for determining when a party is obligated to file an MBT return and pay MBT taxes in Michigan.³⁶ For a non-Michigan financial institution that makes loans secured by Michigan property, such a party has “substantial nexus” for purposes of the MBT if it has “Michigan receipts” of at least \$350,000 in the tax year³⁷ and “actively solicits sales” in Michigan.³⁸

Under the MBT, “Michigan receipts” include interest earned on mortgages secured by property located in Michigan (mortgage income receipts are “sourced” to the location of the property).³⁹ Therefore, a loan secured by Michigan property generates “Michigan

receipts.” The term “actively solicits sales” is not defined in the MBT Act; instead, the MBT Act specifically authorizes the Department to define that term.⁴⁰ The Department issued RAB 2007-6,⁴¹ which replaced its prior SBT nexus guidance in RAB 1998-1, to define the term “actively solicits sales.” The Department’s new RAB makes clear that nexus under the MBT does not require “physical presence” (e.g., the presence of an office or agents in the State).⁴² Instead, the Department defined the term “actively solicits sales” for purposes of the MBT to require only an “economic presence” or some other presence that is less than a physical presence.⁴³

To clarify the Department’s intention to reverse its general nexus position that non-Michigan financial institutions did not have nexus, the Department issued a “Frequently Asked Questions” (“FAQ”) as administrative guidance in this area. The Department’s FAQ makes clear that the MBT nexus determination is made based on a “facts and circumstances” test. The FAQ at issue provides:

F1. Do nonresident financial institutions located outside Michigan whose only activity in Michigan consists of an ownership interest in loans secured in whole or in part by real property located in Michigan have nexus under the MBT?

Answer:

A nonresident financial institution located outside Michigan whose only activity in Michigan consists of an ownership interest in loans secured in whole or in part by mortgages on real property located in Michigan will not have physical presence nexus under the MBT. However, nexus is determined by evaluating all facts and circumstances. To the extent that the nonresident financial institution, or its employee, agent, or independent contractor acting in a representative capacity, has physical presence in Michigan for more than one day, nexus is established. In addition,

⁴⁰ MCL 208.1200(2).

⁴¹ An RAB is a form of administrative guidance issued by the Department that a taxpayer may rely upon prospectively. Specifically, under MCL 205.6(a), 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 RAB 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.)

⁴² Id. This new “economic presence” test is a significant departure from the physical presence test that was applicable under the SBT Act. See RAB 1998-1.

³⁴ Department of Treasury “Questions and Answers” are informal sources of administrative guidance that are subject to change and cannot be relied upon by taxpayers; these are neither promulgated rules, nor regulations adopted pursuant to the Administrative Procedures Act.

³⁵ Single Business Tax Questions and Answers, A17 and A18, 1 Mich. State Tax Reporter (CCH), ¶14-005, p. 1712.

³⁶ MCL 208.1200(1).

³⁷ Gross receipts of an “agent” are excluded for purposes of the MBT, and instead are allocated to the agent’s principals. MCL 208.1111(1)(a).

³⁸ MCL 208.1200(1).

³⁹ MCL 208.1305(4).

nexus also exists if the nonresident financial institution actively solicits sales in Michigan as defined under RAB 2007-6 and has Michigan gross receipts of \$350,000 or more.

Based on the MBT's expanded definition of "nexus," non-Michigan financial institutions making loans to Michigan borrowers should carefully reconsider their Michigan tax filing requirements. A financial institution that never had a filing obligation under the SBT Act may now be required to file MBT returns. In addition, while the Department's FAQ addresses only loans secured by real property, the same "facts and circumstances" analysis should apply to all loans secured by Michigan property.

CONCLUSION

The MBT imposes a tax on financial *institutions* that is very different from the tax financial *organization* paid under the prior SBT. And while the MBT franchise tax on capital is somewhat similar to taxes imposed by other states, the MBT's unitary business group requirement and economic presence nexus standard present new issues for both Michigan and non-Michigan financial entities. All financial organizations that do business in Michigan or make loans that are secured by Michigan property would be well-advised to carefully evaluate their potential filing obligations and tax exposure under the MBT. ■