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REVENUE ADMINISTRATIVE BULLETIN 2010-7

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INDIVIDUAL INCOME TAX - FLOW-THROUGH ENTITY WITHHOLDING TAX

Replaces Revenue Administrative Bulletin 2003-4

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to 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.

RAB 2010-7.

This bulletin describes the income tax withholding and reporting requirements of flow-through entities with nonresident members and business activity in Michigan. In addition, it explains the terms “flow-through entities,” “income available for distribution,” and “tiered entities,” and clarifies the withholding requirements of flow-through entities electing to file composite income tax returns on behalf of nonresident members. This bulletin and these definitions have no application to the Michigan Single Business Tax or the Michigan Business Tax. Finally, this bulletin explains specific exemptions from the flow-through entity withholding requirements of the Michigan Income Tax Act.

This bulletin has been updated to reflect procedural changes in the registration and remittance requirements addressed in issue and conclusion III only. In all other respects this bulletin restates the discussion contained in Revenue Administrative Bulletin 2003-4.

BACKGROUND

The Income Tax Act of 1967 (ITA), was amended by Public Acts 22, 45, 47, 48, 50, and 51 of 2003 to impose income tax withholding and reporting requirements on flow-through entities with nonresident members in the same general manner used to require employers to report and remit withholding taxes on wages.

PA 22 of 2003 enacted a withholding obligation on flow-through entities with nonresident members by amending section 351 of the ITA, MCL 206.351. Withholding is calculated on a nonresident member's taxable share of income available for distribution after allowance is made for personal and dependency exemptions. PA 45 of 2003 amended MCL 206.12 to add

definitions for “flow-through entity,” “member of a flow-through entity,” and “nonresident member” to the ITA. PA 47 amended MCL 206.365 to extend the reporting requirements for withholding tax returns and forms to flow-through entities with nonresident members, and requires nonresident members to furnish a flow-through entity with information needed to make an accurate determination of withholding. PA 48 of 2003 amended MCL 206.355 to extend the general administration, collection, and enforcement provisions of the ITA related to employer withholding taxes to flow-through entities. PA 50 and 51 of 2003 amended the definitions of taxpayer and tax found at MCL 206.26 and 206.22 to include flow-through entities with nonresident members and tax required to be withheld by flow-through entities. These amendments were effective October 1, 2003.

ISSUES

- I. For purposes of these amendments, what are the definitions of “flow-through entities” and “nonresident members of flow-through entities”?
- II. What are the reporting requirements under MCL 206.365 for affected flow-through entities and nonresident members?
- III. How and when will remittances of withholding taxes required under MCL 206.351 be made by flow-through entities with nonresident members?
- IV. For purposes of the flow-through entity withholding requirement under MCL 206.351, what is the definition of the term “share of income available for distribution,” and how is that amount calculated?
- V. What is a tiered flow-through entity structure, and how are the statutory withholding and reporting requirements of flow-through entities administered when the nonresident member is another flow-through entity? How are single member limited liability companies (SMLLCs) and federal qualified subchapter S subsidiaries (QSUBs) that are disregarded entities for federal income tax purposes treated under the flow-through entity withholding requirements of the ITA?
- VI. Are flow-through entities required to withhold taxes from nonresident members participating in a composite income tax return filing, and how is the withholding tax requirement of flow-through entities coordinated with the quarterly estimated tax filing requirements for composite returns?
- VII. Under what circumstances are flow-through entities or nonresident members exempt from the withholding and reporting requirements of the ITA? Does the Department recognize a “de minimis” amount under which no withholding is required?
- VIII. Does the payment of withholding tax by the flow-through entity relieve the individual nonresident member from the obligation to file an annual Michigan income tax return?

CONCLUSIONS

- I. MCL 206.12 was amended by PA 45 of 2003 to define “flow-through entity” to mean an S corporation, partnership, limited partnership, limited liability partnership, or limited liability

company. MCL 206.12 specifically excludes publicly traded partnerships (PTPs) established under section 7704 of the Internal Revenue Code from the definition of flow-through entities for withholding tax purposes. This exclusion applies to PTPs that are treated as corporations as well as PTPs treated as partnerships under IRC 7704(c).

MCL 206.12 also defines “member of a flow-through entity” as a shareholder of an S corporation, a partner in a partnership or limited partnership, or a member of a limited liability company, and further defines “nonresident member” to mean an individual who is not domiciled in this state, a nonresident estate or trust, or a flow-through entity with a nonresident member.

II. Under MCL 206.365 as amended by PA 47 of 2003, three specific types of reporting requirements are identified with respect to flow-through entities incurring withholding tax obligations under MCL 206.351.

Flow-through entities are required to furnish each nonresident member with a statement reflecting the tentative or estimated share of taxable income available for distribution upon which withholding was based and the actual amount of taxes deducted or withheld. This statement must be provided to the nonresident member on or before January 31 of the succeeding year on a form prescribed by the Department. (However, see the exception to this reporting requirement for composite filers in conclusion VI).

A duplicate of the statement furnished to the nonresident member must be provided to the Department no later than February 28 of the succeeding year with an annual reconciliation return, Annual Return for Sales, Use, and Withholding Taxes (form 165).

In addition, the non-resident member is required to provide the flow-through entity with information on which to base an accurate determination of withholding tax by completing a form W-4, Employees Michigan Withholding Exemption Certificate. This form must be refiled with the flow-through entity only if the number of dependency exemptions of the member changes.

III. Remittance of withholding taxes by flow-through entities must be calculated quarterly by using form 3862, Monthly or Quarterly Sales and Use Tax Worksheet, and the payment shall be remitted using the payment voucher, form 160, Combined Return for Michigan Taxes. The due date of the remittance will be the 20th day of the month following the quarter's end. The quarterly due dates will generally be April 20, July 20, October 20 of the taxable year, and January 20 of the succeeding year.

Flow-through entities that are required to withhold Michigan income tax on nonresident members' Michigan income must register with the Department for flow-through withholding. Flow-through entities that were previously registered for other Michigan taxes must submit a new form 518 to register for flow-through entity withholding. The form 518 should be filed on line or faxed or mailed to the Department using the fax number or mailing address printed on the bottom of the form. The Department will issue an identification number for use on the flow-through entities' withholding tax returns that is different from the employer identification number used to file and pay employee withholding tax returns. The Department requires different identification numbers and separate reporting for internal accounting purposes. A flow-through entity may *not* report and pay flow-through entity withholding taxes on the same forms

and returns used to report and pay employee withholding taxes. Separate 160 and 165 forms must be submitted to report and pay flow-through entity withholding.

A flow-through entity which paid in the immediately preceding calendar year an average of \$40,000.00 or more per month in income tax withholding on the combined share of income available for distribution and employee wages shall deposit the Michigan tax withheld at the same time and in the same manner as deposits of federal withholding taxes. Generally this will require an electronic funds transfer in accordance with the time frames provided in the IRC and may be as soon as the day after "withholding." Flow-through entity withholding is deemed to occur on the last day of the quarter, and remittance of the withholding for the affected accelerated filers must be made by electronic funds transfer at any subsequent time, but not later than the 20th day of the month following the end of the quarter. Flow through entity withholding should be deposited through a electronic funds transfer that is separate from the one being used to deposit any other Michigan taxes.

IV. A non-resident member's share of taxable income available for distribution is the distributive share of the net profits of the flow-through entity that will be included at year end in the adjusted gross income of the nonresident individual's annual federal income tax return, and reported on the member's federal K-1 form. The share of taxable income available for distribution determined by reference to the federal income tax return and K-1 form of the member may be further reduced by any income that is specifically excluded or exempt from Michigan income tax, such as income from U.S. obligations or gross revenues from oil and gas production subject to Michigan's severance tax. In addition, if the flow-through entity is properly taxable in Michigan and one or more other states, the share of taxable income available for distribution may be reduced by that portion of income attributed to other states under the 3 factor apportionment provisions of the ITA.

Since the share of taxable income available for distribution must be calculated on a quarterly basis, the federal K-1 information will not be available at the time the remittance of withholding tax is due. If the flow-through entity is unable to make an accurate determination of the member's share of taxable income available for distribution using financial information from the immediately preceding 3 months, the Department will allow withholding calculations based on one of the following methods:

- (1) Michigan taxable income from the first and second months of the quarter, and the last month of the preceding quarter;
- (2) Profit and loss statements or book income from the current quarter combined with the apportionment factor from the immediately preceding tax year;
- (3) Michigan taxable income from the immediately preceding tax year;
- (4) Any alternative method previously approved by the Department that results in a reasonable and accurate estimate of the amount of withholding tax due for the quarter.

The method selected for use in calculating quarterly withholding payments must be consistent throughout the tax year. If 3 factor apportionment is involved, a calculation or reasonable estimate of the property, payroll, and sales factor for the quarter must be made unless the flow

through entity elects to base an estimate on the use of one of the alternative methods employing prior year apportionment data.

V. A flow-through entity that has one or more members that are other flow-through entities is categorized as a tiered entity. A tiered entity structure that has at least one nonresident individual, estate, or trust as a member and business activity in Michigan has withholding and reporting requirements under the ITA as amended by the Public Acts affecting flow-through entities. Only the flow through entity with business activity in Michigan is liable for the withholding tax.

A flow through entity that receives distributive share income from another flow through entity with business activity in Michigan has no withholding obligation on its distributive share of Michigan income from the other flow through entity. A flow-through entity that includes a member that is another flow-through entity with nonresident individual owners shall withhold Michigan income tax from the share of income available for distribution of the member flow-through entity without regard to any allowances for personal dependency exemptions of the member flow-through entity's individual owners. Exception: If the member flow-through entity provides W-4 information and ownership percentage of its individual owners to the flow-through entity in which it has an ownership interest, then that flow-through entity shall withhold Michigan income tax from the member flow-through entity's share of income available for distribution on the basis of the personal dependency exemptions and ownership percentage of its individual shareholders or partners.

The flow-through entity that has a withholding requirement shall fulfill the reporting requirements of MCL 206.365 by reporting the share of income available for distribution and amount of tax withheld directly to the individual shareholders or partners of the member flow-through entity if it has been provided with the necessary W-4 information and ownership percentages to enable it to do so. If the member flow-through entity in a tiered entity structure elects not to provide the W-4 and ownership percentages of its nonresident individual owners to the flow-through entity in which it has an ownership interest, then the flow-through entity required to withhold shall report the required income and withholding information directly to the member flow-through entity.

An entity that is disregarded as an entity separate from its owner under the Internal Revenue Code, such as a QSUB or SMLLC, is deemed to be the same entity as its owner for federal income tax reporting purposes. The disregarded entity and its owner file a single federal return combining the activities and aggregating the income, deductions, and credits of each on the owner's federal return. Since the taxable share of income available for distribution is computed by reference to the combined income of the disregarded entity and its owner, and reported by the owner to its members on federal K-1 forms, an owner that is another flow-through entity, such as a partnership or S corporation, is responsible for any flow-through entity reporting and payment requirements under the ITA that may arise through the activity of the QSUB or SMLLC. A SMLLC treated as a sole proprietorship under the Internal Revenue Code is subject to, and responsible for compliance with, the flow-through entity withholding provisions of the ITA.

VI. A flow-through entity with nonresident members may elect to file a composite Michigan income tax return on behalf of its nonresident members. Prior to enactment of the legislation

imposing flow-through entity withholding tax requirements, flow-through entities filing composite returns were required to file and pay quarterly estimated tax payments if the annual tax due was expected to exceed a statutory threshold. Nonresident members of a flow-through entity that elected not to participate in the composite filing were also required to file quarterly estimates if the annual tax due on their individual income tax returns was expected to exceed the statutory threshold.

Under PA 22 of 2003, a flow-through entity is required to withhold income tax on a nonresident member's share of taxable income available for distribution effective October 1, 2003. Flow-through entities with nonresident members that participate in composite filings will be required to make withholding tax remittances beginning with the January 15, 2004 payment for the 4th quarter of 2003. Payments will be made in the same manner and at the same times required by flow-through entities that do not participate in composite filings. The withholding tax requirements will be in place of the quarterly estimated tax requirements for both flow-through entities filing composite returns and members filing individual returns.

A flow-through entity that files a composite return is not required to provide a copy of the annual report of the income available for distribution and tax withheld to any member participating in the composite filing. However, this information must be provided to the Department when the composite return is filed. A credit for the tax paid through withholding will be allowed on the composite return.

VII. Publicly Traded Partnerships (PTP)s as defined under section 7704 of the Internal Revenue Code and not treated as a corporation under section 7704(c) are specifically exempted from the flow-through entity withholding requirements established by PA 22 of 2003 in MCL 206.351. However, PA 48 of 2003 amended MCL 206.355 to require PTPs exempt from the withholding provisions of MCL 206.351 to file a report on or before August 31 of all unit holder information from the PTPs federal schedule K-1s (form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, of the immediately preceding calendar year. This report shall be made by a paper or electronic format on a form prescribed by the Department. (Note: The reporting requirement for PTPs only applies to PTPs not treated as corporations under section 7704(c) of the IRC).

In general, the income available for distribution of other types of flow-through entities with business activity in Michigan will be exempt from the withholding requirements of the ITA if: 1) the income available for distribution consists entirely of income exempt from Michigan income tax, such as income from U.S. obligations or oil and gas production; 2) the member is a resident individual, estate or trust, or an entity exempt from Michigan income tax, such as a non profit organization or a C corporation, or; 3) the aggregated income available for distribution of all nonresident members subject to withholding tax is less than \$1,000 for any quarter.

VIII. Compliance with the withholding requirements of the ITA by a flow-through entity does not relieve a nonresident member from the obligation to file an annual Michigan income tax return, in either a composite or individual return format. The member must file an annual Michigan income tax return and claim a credit for their proportionate share of tax withheld by the flow-through entity.

LAW AND ANALYSIS

For federal income tax purposes, a flow-through, or pass-through, entity is generally defined as a taxable entity whose income, deductions, and credits are reported and taxed at the owner's level rather than at the entity's level. Common examples of flow-through entities for federal income tax purposes are S corporations under sub chapter S of the IRC and partnerships under subchapter K of the IRC. For individual income tax purposes, an owner of a flow-through entity reports his or her distributive share of the net income or loss from the partnership or S corporation on an individual income tax return (U.S. form 1040), subject to certain statutory limits, such as the passive activity loss limitations under section 469 of the IRC, that are determined at the partner or shareholder level. C corporations under subchapter C of the IRC and certain other organizations required to be treated as corporations for federal purposes, such as a trust operating a business, are subject to federal income tax at the entity level, and are not considered flow-through entities even though the owners may be subject to federal income tax on dividend distributions.

Nonresidents of Michigan are subject to income tax on Michigan sourced income as defined in MCL 206.110(2), including business income. Section 110(2)(b) of the ITA states, in part, that all taxable income of a nonresident individual, estate, or trust is allocated to this state to the extent it is earned, received, or acquired as a distributive share of the net profits of a business, profession, enterprise, undertaking, or other activity as the result of work done, services rendered, or other business activities conducted in this state. Section 103 of the ITA requires both resident and nonresident taxpayers having income from a business activity, which is taxable both within and without this state to apportion the net business income as prescribed in sections 115 through 195 of the ITA. Because the computation of Michigan taxable income begins with an individual's federal adjusted gross income, a nonresident's apportioned share of distributive income from a flow-through entity reported in federal adjusted gross income is attributable to Michigan and potentially subject to Michigan income tax.

Prior to October 1, 2003, a nonresident individual subject to Michigan income taxes on a distributive share of profits from a flow-through entity with business activity in Michigan was required to file and pay quarterly estimated tax payments if the anticipated annual income tax liability was expected to exceed a designated threshold amount. Effective October 1, 2003, flow through entities as defined in the ITA are required to withhold Michigan income taxes from a nonresident member's distributive share of Michigan taxable income. While the amendment requiring withholding taxes does not affect the imposition of tax or change the calculation of a nonresident's share of Michigan taxable income from a flow-through entity, it does impose additional tax payment and reporting requirements at the entity level, and, in most cases, eliminates the quarterly estimated filing and payment requirement at the individual level.

A nonresident individual, estate, or trust, with Michigan sourced income is required to file an annual Michigan income tax return. Any withholding tax or other payments made by or on behalf of the nonresident may be claimed for credit on the annual income tax return.