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Treasury Update

In this issue:

Stay Informed!

Current and past editions of "Treasury Update" are now located on their own page on Treasury's website. The new page can be found under the Reports and Legal Resources tab.

Important Changes to Flow-Through Withholding

The flow-through withholding obligation imposed under Part 3 of Michigan's Income Tax Act (MCL 206.701-206.713) requires some flow-through entities with Michigan business activity to withhold income tax on each member's or owner's distributive share of income. Withholding requirements may apply when members are nonresident individuals, C corporations, or other flow-through entities. **Under Public Act 158 of 2016 (PA 158), flow-through withholding is no longer required for flow-through entities effective for tax years beginning after June 30, 2016.** This means that a flow-through entity with a calendar tax year ending December 31, 2016, for example, that was required before PA 158 to withhold under Part 3 of the Income Tax Act (MCL 206.701-206.713) must continue to withhold on behalf of its members for its full tax year. Withholding is no longer required for tax years after the calendar 2016 tax year. A flow-through entity with a tax year beginning July 1, 2016, and ending June 30, 2017, however, is not required to withhold for that tax year or any succeeding tax year. Flow-through entities in a tiered structure should withhold and apply the cut-off based on their own tax year.

If a taxpayer under the Corporate Income Tax (CIT) or the Individual Income Tax (IIT) has a distributive share of business income attributable to a flow-through entity's tax year beginning after June 30, 2016, that taxpayer will not have withholding from that flow-through entity to claim on its annual return. This should be considered by the CIT or IIT taxpayer when determining its quarterly estimated payments. Flow-through entities filing a Composite Individual Income Tax Return (Form 807) on behalf of nonresident individuals may now be required to file quarterly estimated payments, and should pay them using the Fiduciary Voucher for Estimated Income Tax (Form MI-1041ES).

Regardless of the requirement to withhold, a flow-through entity must continue to report certain information to its members, because both individuals and CIT taxpayers require this information to complete their income tax returns. A flow-through entity may use any method to report the information to its members, but the Department of Treasury recommends that the information be provided as a supplemental attachment to the member's federal Schedule K-1. The following information must be conveyed:

- The FEIN of the flow-through entity.
- The tax year of the flow-through entity.

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- The amount of flow-through withholding paid on behalf of that member. For nonresident individual members that will participate in a Composite Individual Income Tax Return (Form 807), report instead the member's share of the tax paid by the flow-through entity on the composite return.
- For members subject to IIT, the member's distributive share of taxable income attributable to the flow-through entity. For members subject to CIT, the member's distributive share of business income and the member's share of statutory additions and subtractions before apportionment, attributable to the flow-through entity.
- The amount of the flow-through entity's sales that are sourced to Michigan.
- The flow-through entity's total sales.
- For members that are corporations or other flow-through entities, the amount of the flow-through entity's gross receipts. Members will report their proportionate share of allocated or apportioned gross receipts from flow-through entities on their CIT returns.

For more information, see Treasury's recent Notice to Taxpayers regarding the repeal of flow-through withholding.

Update on *LaBelle Management* Litigation: Defining Indirect Ownership

As reported in the May 2016 issue of Treasury Update, on March 31, 2016, the Michigan Court of Appeals in *LaBelle Management, Inc. v Dep't of Treasury*, ___ Mich App ___ (2016), rejected the Department of Treasury's published guidance defining indirect ownership for purposes of defining unitary business groups under the Michigan Business Tax (MBT). In rejecting Treasury's established definition, which relied upon the attribution rules of Internal Revenue Code § 318, the Court turned to various dictionary definitions and determined that indirect ownership means ownership through an intermediary. The decision uprooted taxpayers' reliance on portions of Revenue Administrative Bulletin 2010-1 in structuring their organizations and leaves many unanswered questions in its wake. The appellate court's ruling may affect as many as 30,000 unitary business group filers in each of the open years, splintering those groups and requiring new or amended filings.

Immediately after the Court of Appeals decision, Treasury filed a motion to stay as well as a motion for reconsideration. The Court granted Treasury's motion to stay the effect of the decision until all appeals in the case have been exhausted, but denied Treasury's request to reconsider and clarify the decision. Subsequently, on June 27, 2016, Treasury filed an Application for Leave to Appeal to the Michigan Supreme Court. LaBelle filed its response to Treasury's Application, and the parties await the Supreme Court's determination whether to hear the case. For more information, see Treasury's Notice to Taxpayers regarding the *LaBelle Management* case.

Contractor Liability for Use Tax

In the construction industry, it is not unusual for a federal, state, or local government agency or nonprofit organization to hire a contractor for construction of a new building, addition, or other project. Governmental entities and certain nonprofit organizations are exempt from sales and use taxes when they purchase tangible personal property. Accordingly, there is a misconception among some in the construction industry that a contractor is not liable for use tax on materials used or consumed by the contractor in the performance of the construction contract if those materials were originally purchased by the government agency or nonprofit organization in a sales or use tax exempt transaction.

Michigan's Use Tax Act imposes a tax on every person that uses, stores, or consumes tangible personal property in Michigan at a rate of 6% of the purchase price, unless sales tax was paid when the property was purchased or another exemption applies. MCL 205.93(1). A taxable "use" means the exercise of a right or power over tangible personal property incident to the ownership of that property including a transfer of the property in a transaction where possession is given. MCL 205.92(b).

For use tax purposes, a "consumer" includes a person acquiring tangible personal property if that person is engaged in the business of constructing, altering, repairing, or improving the real estate of others. MCL 205.92(g)(i). Accordingly, contractors are "consumers" of materials acquired, used and/or consumed by them when engaged in the business of constructing, altering, repairing, or improving real estate of others.

Unless otherwise exempt (e.g., property affixed to or made a structural part of a sanctuary under MCL 205.94m(1)), a contractor is liable for use tax for tangible personal property used or consumed in the performance of the construction contract regardless whether the contractor purchased or owns the property that is ultimately affixed to real estate or acquired that property from an entity that originally purchased it exempt from sales or use tax.

> Example: A nonprofit school purchases building materials in a tax-exempt retail transaction and provides the materials to the contractor for use or consumption in constructing a new building on the school's property. The contractor is liable for use tax equal to the purchase price paid by the school for the tangible personal property that was ultimately used or consumed by the contractor in performing the construction contract.

Similarly, unless an exemption otherwise applies, a contractor is liable for use tax on tangible personal property that is ultimately affixed to – and/or made a structural part of – real estate by the contractor in the performance of the contract with its customer even if: (i) the property was acquired from its customer and the customer claimed an exemption from sales or use tax (e.g., industrial processing under MCL 205.94o or utilized a direct pay authorization under MCL 205.98(1)) at the time the customer purchased the tangible personal property at retail, or (ii) the contractor received a claim of exemption from its customer and the basis for the exemption was one related to property that is not affixed to real estate, such as the industrial processing exemption or a direct pay authorization. Contractors should take into account this potential use tax liability when bidding on projects.

It should also be noted that a contractor that acquires tangible personal property for an exempt use, but then uses that property for a taxable use (including an interim taxable use) is liable for use tax based on the purchase price of the property, whether the non-exempt use is in whole or in part, or permanent or not permanent, and regardless of any subsequent tax-exempt use. MCL 205.93(1), 205.92(q), and 205.97(2).

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Treasury expects a Revenue Information Bulletin addressing the application of the Use Tax Act to the construction industry to be published soon. For more information regarding whether property remains tangible personal property or becomes a fixture through its affixation to real estate for purposes of the General Sales Tax Act and the Use Tax Act, please refer to Revenue Administrative Bulletin 2016-4.

Alert: Transfer of Controlling Interest in Entity May Trigger Transfer Tax

The State Real Estate Transfer Tax (SRETT) (1993 PA 330, MCL 207.521 *et seq.*) is an excise tax on the privilege of recording transfers of real property. Subject to certain exemptions, most transfers of real property in Michigan are subject to SRETT. Some are also subject to a county real estate transfer tax.

The transfer tax burden is placed upon the seller or grantor of any interest in real property and is due at the time the deed, easement, assignment, or other instrument of conveyance is offered to the Register of Deeds for recording. The tax is levied at the rate of $3.75 for each $500 or fraction of $500 of the total value of real property transferred.

One transaction subject to SRETT that taxpayers often overlook is the acquisition or transfer of a controlling interest in an entity that owns real property. "Controlling interest" means more than 80 percent of the total value of all classes of stock of a corporation, more than 80 percent of the total interest in capital and profits of a partnership, association, limited liability company, or other unincorporated form of doing business, or more than 80 percent of the beneficial interest in a trust.

To trigger the tax, real property must comprise 90% or more of the fair market value of the entity's assets as determined under generally accepted accounting principles (GAAP).

The SRETT Act exempts from tax a transfer of a controlling interest in an entity with an interest in real property if the transfer of the property would have otherwise qualified for exemption if the transfer was one that could have been accomplished by deed between the parties to the transfer. For example, a conveyance of real property from a parent to child is exempt from SRETT. Accordingly, the transfer from parent to child of a controlling interest in an entity holding 90% or more of its GAAP assets in real property is likewise exempt from SRETT.

The purchase contract, transfer agreement, or Valuation Affidavit (Form 2705) must be presented to the Register of Deeds for recording and SRETT must be paid to the County Treasurer in the county where the real property is located. The tax must be paid within 15 days of the transfer of the controlling interest.

For questions, ideas for future newsletter or Revenue Administrative Bulletin topics, or suggestions for improving Treasury Update, please contact:

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Litigation Update: IBM Entitled to Judgment Notwithstanding Retroactive Compact Repeal

The enactment of Public Act 282 of 2014 (PA 282) in September 2014 retroactively repealed the Multistate Tax Compact (Compact) effective January 1, 2008. The repeal extinguished any election that a taxpayer may have had to apportion income using the Compact's equally-weighted 3-factor methodology in lieu of the method under state law. PA 282 was enacted in response to the Michigan Supreme Court's decision in *IBM v Dep't of Treasury*, in which the Court held that IBM was entitled to elect to apportion its 2008 Michigan Business Tax (MBT) base under the Compact rather than the MBT Act's apportionment formula. In its 4-3 decision, the Court reversed the Court of Claims and the Court of Appeals, and remanded the matter back to the Court of Claims "for entry of an order granting summary disposition in favor of IBM." PA 282 was enacted pending the Court's action on the Department of Treasury's motion for rehearing. On remand, following a motion for reconsideration, the Court of Claims found that PA 282 was an intervening change of law such that the "law of the case" doctrine, which would generally bind a lower court to follow a ruling by the appellate court in the case, did not impede its ability to independently review the underlying issue in light of the new statute.

In an opinion issued July 21, 2016, the Court of Appeals reversed the Court of Claims' decision. The appellate court held that IBM was entitled to apportion its 2008 MBT tax liability using the Compact's apportionment formula because the lower court had no authority to rule for Treasury and, instead, was required to only undertake the ministerial task of entering summary disposition in favor of IBM. The appeals court ruled that the Court of Claims could not exceed the scope of the Supreme Court's remand order, basing its analysis not on the "law of the case" doctrine, but on a principle the court termed the "rule of mandate." The Court of Appeals opined that the Supreme Court's instruction mandated a "ministerial entry of a judgment in favor of IBM," and that the remand mandate "foreclosed all other possibilities and any renewed litigation over IBM's 2008 business taxes," notwithstanding the Legislature's enactment of PA 282. The court further ruled that once the case left the Supreme Court's jurisdiction, the case was over, except for the formal entry of judgment. Permitting PA 282 to be applied to IBM with respect to its 2008 MBT taxes, staed the court, would effectively result in the "impermissible legislative reversal" of the Supreme Court's decision.

The Court of Appeals noted that its previous decision upholding the constitutionality of PA 282 and its retroactive effect* did not change its analysis, asserting that the previous decision could not overrule the Supreme Court's earlier opinion in *IBM v Dep't of Treasury* and the resolution of the specific issues of IBM's 2008 MBT taxes. The court stressed, however, that PA 282, upheld in the *Gillette* decision, applies to all other pending disputes involving the statute's retroactive effect on the Compact's apportionment election.

With respect to those other pending disputes, the Michigan Supreme Court has denied a group of taxpayers' applications for leave to appeal the Court of Appeals' decision in *Gillette* upholding PA 282. Any further review of the *Gillette* decision would have to come from a grant of *certiorari* by the U.S. Supreme Court.

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* See *Gillette Commercial Operations North America & Subsidiaries v Dep't of Treasury* (September 29, 2015).

Treasury White Paper: What is the Streamlined Sales and Use Tax Project?

Michigan participates in the Streamlined Sales and Use Tax Project (SSTP). The project began in March 2000 and is a cooperative effort between state and local governments and the business community to simplify and make sales and use tax collection more uniform. It is intended to reduce the cost and administrative burdens on retailers that collect sales and use taxes, particularly retailers operating in multiple states. Businesses, including national retailers, trade associations, manufacturers, direct marketers, telecommunications companies, and others, actively participate in the SSTP by offering expertise and input, reviewing proposals, and suggesting legislative language.

SSTP began because many out-of-state retailers do not collect and remit taxes on sales into states in which they do not have a physical presence. These out-of-state retailers are often referred to as "remote sellers" and are generally businesses that sell products to customers using the Internet, mail order, or telephone. These retailers currently cannot be required to collect and remit sales tax as brick-and-mortar stores must do because of a U.S. Supreme Court ruling in 1992 (*Quill vs. North Dakota*) which determined that the burden of collection on out-of-state retailers was too high.

With the growth of e-commerce, concern has grown over the inability of states to require collection of their taxes from "remote sellers." Many believe that not requiring out-of-state retailers to pay tax is unfair because it disadvantages "brick and mortar" businesses located within the state who must pay tax. Sometimes local stores find themselves serving as showrooms for out-of-state retailers. Prospective customers check out the merchandise locally, but buy the product online to avoid paying sales tax. As this growth trend continues, there is also concern about the fiscal consequence on state budgets due to the unpaid taxes associated with "remote sellers." Recent estimates indicate that Michigan revenue losses are projected to grow in fiscal year 2017 to $468 million in unpaid use taxes attributable to remote sales.

The SSTP has attempted to reduce the burden on "remote sellers" of collecting and reporting taxes by creating a voluntary and simplified system designed to bring uniformity to definitions of items in the sales tax base, significantly reduce the paperwork burden on retailers, and incorporate new technology to modernize many administrative procedures. Retailers who voluntarily register with the SSTP remit tax to the states they are doing business in. If you are a retailer who makes sales in more than one state, consider registering with the SSTP. It allows retailers to collect and remit sales tax in multiple states. Currently, 24 states, including Michigan, participate in the SSTP through membership in the Streamlined Sales and Use Tax Agreement. Retailers who register with the SSTP can also take advantage of using a certified service provider to file and remit sales tax for little or no cost. A list of certified providers can be found on the Streamlined Sales Tax Governing Board's website.

> Special Note: While the SSTP is a voluntary system, effective October 1, 2015, Michigan enacted a new nexus statute that seeks to address some of the disparity between in-state and out-of-state retailers. The new statutory requirements create rebuttable presumptions regarding the circumstances under which an out-of-state retailer will be deemed engaged in business in Michigan and required to collect and remit sales and use taxes. These requirements were discussed in the November 2015 edition of Treasury Update. Further information regarding Michigan's tax registration and remittance requirements is available on our website or you can call us at 517-636-4357.

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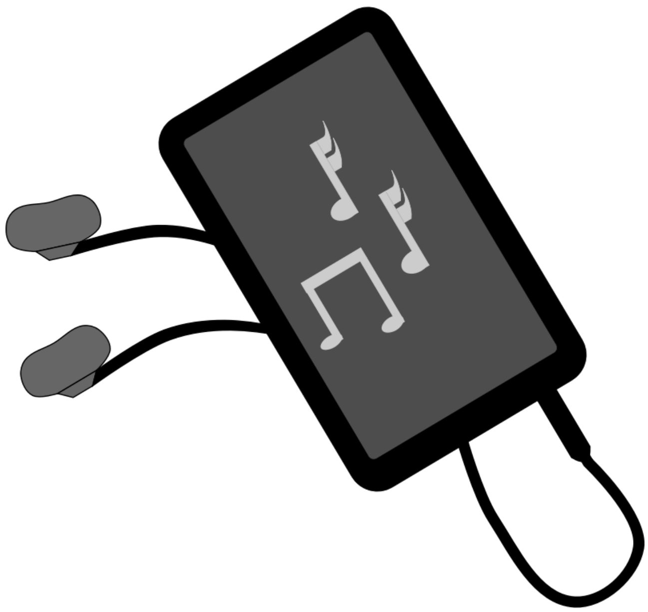
This Treasury White Paper is the first in an occasional series of reports or guides intended to inform Michigan taxpayers and tax practitioners about a complex, multi-faceted, or little-known issue related to state taxation, and to explain Treasury's policy or philosophy with respect to the matter. White papers such as this one are meant to provide background that will help readers understand an issue, solve a problem, or make a decision.

Treasury welcomes suggestions for topics to be addressed in the White Paper series. See page 4 for information on contacting us.

The Digital Revolution: Digital Products are Here to Stay



The "digital revolution" refers to the sweeping changes brought about by digital computing and communication technology during the latter half of the twentieth century — changes that continue to the present day. As our society continues to move from a tangible economy to a digital economy, we encounter digital products on a daily basis, through our activities at home, work, and play. Many items formerly sold only as items of tangible personal property are now being offered in a digital form. Sometimes the digital item completely replaces a tangible item, while other times it is simply a convenient alternative.

In general, a digital product for sales and use tax purposes is a product that is accessed or obtained electronically. By statute, Michigan imposes tax on the sale or use of certain prewritten computer software products. However, there is no specific tax imposition on the sale or use of other types of digital products.

Consequently, it is the Department of Treasury's current position that the sale of digital goods such as e-books, podcasts, electronic music (such as that purchased through iTunes) and telephone ringtones are not taxable under Michigan law. This is true whether the goods are downloaded, streamed, or accessed through a subscription service.

The following are some examples of taxable tangible personal property versus non-taxable digital goods:

- ◊ Recorded music produced and sold in the form of a vinyl LP, cassette tape, or compact disk is taxable tangible personal property. Recorded music that is sold in an MP3 or other electronic format and is transferred electronically to the purchaser is considered a digital good and is not taxable in Michigan.
- ◊ A movie purchased in DVD form from a retailer is taxable tangible personal property. A movie that is "streamed" over the Internet by the retailer to the purchaser (the purchaser watches the movie as it is being "streamed") is a digital good and therefore is not taxable in Michigan.
- ◊ A book sold in hardcover or paperback form is taxable as a sale of tangible personal property. The sale of the same book in any of the various e-book formats is the sale of a digital good and is not taxable in Michigan.

While Michigan does not impose a tax on the sale of these types of digital goods, consumers should be aware that many other states do.

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* "Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched or that is in any other manner perceptible to the senses and includes electricity, water, gas, steam, and prewritten computer software. Sales Tax Act: MCL 205.52, MCL 205.51a(q); Use Tax Act: MCL 205.93, MCL 205.92(k).

Statement of Acquiescence/Non-Acquiescence Regarding Certain Court Decisions

In each issue of the quarterly *Treasury Update*, Treasury will publish a list of final (unappealed), non-binding, adverse decisions issued by the Court of Appeals, the Court of Claims and the Michigan Tax Tribunal, and state its acquiescence or non-acquiescence with respect to each. The current quarterly list applying Treasury's acquiescence policy appears below. "Acquiescence" means that Treasury accepts the holding of the court in that case and will follow it in similar cases with the same controlling facts. However, "acquiescence" does not necessarily indicate Treasury's approval of the reasoning used by the court in that decision. "Non-acquiescence" means that Treasury disagrees with the holding of the court and will not follow the decision in similar matters involving other taxpayers.

ACQUIESCENCE:

No cases this quarter

NON-ACQUIESCENCE:

Central Michigan Cementing Services, LLC v Dep't of Treasury, COA Docket Number 323405 (December 8, 2015)

RECENTLY ISSUED GUIDANCE FROM TREASURY

REVENUE ADMINISTRATIVE BULLETINS:

RAB 2016-10 Revenue Act Interest Rate
RAB 2016-13 Individual Income Tax – Railroad Employee Benefits
RAB 2016-14 Sales and Use Tax Exemption Claim Procedures and Formats

INTERNAL POLICY DIRECTIVES:

IPD 2016-3 Homestead Property Tax Credit Calculation for Claimants Living in Special Housing

OTHER GUIDANCE:

Notice to Taxpayers: Repeal of Flow-Through Withholding on Members' Distributive Share of Income
Notice to Taxpayers: Notice Regarding *LaBelle Management, Inc. v Dep't of Treasury*