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The End of the MBT Surcharge

Shortly before the Michigan Business Tax (MBT) took effect on January 1, 2008, Public Act 145 of 2007 (MCL 208.1281) was enacted. The purpose of this amendment to the MBT was to remedy anticipated deficiencies in state funds by imposing an annual surcharge on the MBT.

The surcharge imposed on a standard taxpayer was 21.99% of the tax liability after allocation and apportionment and before the application of credits. For a financial institution, the surcharge was 27.7% for tax years ending after December 31, 2007, and before January 1, 2009, and 23.4% for tax years ending after December 31, 2008. The surcharge was capped at $6 million for standard taxpayers for any single tax year. There was no cap on the MBT surcharge for financial institutions.

The Act called for the elimination of the surcharge effective January 1, 2017, if Michigan experienced positive personal income growth, as defined the U.S. Department of Commerce's Bureau of Economic Analysis, in either 2014, 2015, or 2016. Michigan satisfied those personal income growth requirements and the surcharge is no longer imposed on the remaining taxpayers who continue to file and pay the MBT.

The Instructions to the 2016 MBT Annual Return Form 4567 (at www.michigan.gov/documents/taxes/4567_546630_7.pdf) note that the surcharge expired effective January 1, 2017, and explains how fiscal year taxpayers with tax years that straddle that date are to calculate the effective surcharge to be imposed on liability for the tax year. The surcharge is calculated by dividing the number of months in the filer's tax year contained in calendar year 2016 by the total number of months in the filer's tax year. The resulting prorated surcharge is then applied to the taxpayer's MBT liability before application of credits. Forms and instructions for 2017 will reflect the end of the surcharge.

Taxpayers Need Better Reporting from Flow-Through Entities

Each year that a partnership, S corporation, or LLC taxed as a partnership (collectively, a "flow-through entity") has business activity in Michigan, it must report information about its tax year to its owners. Federally, information is reported on Schedule K-1 (1065 or 1120S). Partners, shareholders, and members (collectively, "owners") subject to Michigan's CIT or individual income tax need state-specific information to properly fill out their tax returns. Owners often need far more detail than what is initially provided, which can cause delays in return processing and audits.

A flow-through entity may use any method to report Michigan information to owners. Treasury recommends providing a supplemental attachment to the owner's federal Schedule K-1. Many states publish a mandatory state-level K-1 but Michigan does not. Some software providers have programmed their own "Michigan-equivalent K-1." While software-developed schedules will be accepted, please note that none have been preapproved or specifically endorsed by the Department of Treasury. The following information should be conveyed to the owner:

- FEIN of the flow-through entity
- Tax year of the flow-through entity
- Flow-through withholding paid on behalf of that owner (if applicable)
- For owners subject to individual income tax, the owner's distributive share of taxable income attributable to the flow-through entity. For owners subject to CIT, the owner's distributive share of business income and the owner's share of statutory additions and subtractions, attributable to the flow-through entity. All amounts should be reported without regard to apportionment.*
- Flow-through entity's sales sourced to Michigan**
- Flow-through entity's total sales**
- For owners that are corporations or other flow-through entities, the flow-through entity's gross receipts. Owners will report on CIT returns their proportionate share of allocated or apportioned gross receipts from flow-through entities.

Information reported to a participant of a Composite Individual Income Tax Return differs slightly. Owners that are C Corporations are not eligible to participate in a composite filing. For more information, please see Form 807.

*** Reporting for CIT members:** "Business income" is calculated as federal taxable income as if IRC 168(k) and 199 were not in effect. Those sections of the code deal with bonus depreciation and the Domestic Production Activities Deduction (DPAD), respectively. A corporate owner is required to make these two adjustments to federal taxable income, even though they are attributable to its ownership in a flow-through entity. Likewise, a corporate owner must also make adjustments to its business income for statutory additions and subtractions, even though they are attributable to ownership in a flow-through entity.

**** More than the apportionment percentage is needed.** CIT and individual income tax returns require taxpayers to report Michigan sales and total sales separately, including for the apportionment of flow-through income and loss.

Jenks v Michigan Dep't of Treasury: Uncontested Assessments Become Final Once Statutory Appeal Period Expires

In *Jenks v Dep't of Treasury*, an unpublished opinion by the Court of Appeals (No. 332787), dated June 15, 2017, the court affirmed the decision of the Michigan Tax Tribunal ("Tribunal") that held the taxpayer's claim for refund amounted to a "collateral attack" on final assessments barred by MCL 205.22(4) and (5).

A taxpayer who receives a tax assessment is entitled to appeal the contested portion of the assessment to the Tribunal within 60 days or to the Court of Claims within 90 days after the assessment. MCL 205.22(1). However, if the assessment is not timely appealed, then the assessment becomes final and is not reviewable in any court. Further, a taxpayer is not entitled to a refund of any tax interest or penalty paid pursuant to the assessment unless the aggrieved person has appealed the assessment in the manner provided. MCL 205.22(4) and (5). Here, taxpayer did not exercise the appeal rights related to the assessments issued.

Almost two years after assessment, the taxpayer sought to reopen the debate over all tax assessments issued against him by paying a small portion of 16 different tax assessments that he had failed to appeal, and asking for an informal conference. He appealed the informal conference decision to the Tribunal and claimed a right to refund, declaring he had been unjustly assessed. Viewed as a collateral attack, the Tribunal dismissed the matter, determining that the assessments had become final, conclusive and no longer subject to challenge after the time to appeal to the Tribunal expired.

On appeal, the Court of Appeals opined that, under MCL 205.22(5), after an assessment is final and has not been timely appealed, "a person is not entitled to a refund of any tax, interest, or penalty paid pursuant to an assessment unless the aggrieved person has appealed the assessment." The record established that Taxpayer never appealed the final assessments as provided for in MCL 205.22(1) and that the taxpayer's attempt to challenge final and conclusive assessments was barred by MCL 205.22(4) and (5).

Recently Issued Guidance from Treasury

Revenue Administrative Bulletins

- **RAB 2017 – 6**
  Individual Income Tax – Treatment of Rental Income as Business or Nonbusiness Income

Other Guidance

- Notice to Taxpayers Regarding the Conclusion of Multistate Tax Compact Election Litigation

*Revenue Administrative Bulletins (RAB) and other guidance can be found on the website at **Michigan.gov/Treasury** under the **Reports and Legal Resources** tab.*

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:
No cases this quarter

Court Addresses the Definition of "Compensation" When Determining Eligibility for the Small Business Alternative Credit

Four Zero One Associates, LLC v Dep't of Treasury, ___ Mich App ___(Docket No. 332639) (2017), involved the definition of "compensation" for purposes of determining eligibility for the Small Business Alternative Credit (SBAC) under the Michigan Business Tax Act (MBTA).

The SBAC provided in the MBTA is reduced or eliminated entirely if compensation exceeds certain thresholds. Specifically, Four Zero One's entitlement to the SBAC was controlled by MCL 208.1417(1)(b)(i), which prescribes that:

> (b) A corporation other than a subchapter S corporation is disqualified if either of the following occur for the respective tax year:
> (i) Compensation and directors' fees of a shareholder or officer exceed $180,000.00.

Central to the case was the amount of compensation paid to a particular officer and shareholder in the 2008 tax year. The Department denied the SBAC because his compensation totaled $193,996.00, which included a $30,000.00 bonus paid to him in 2008. Four Zero One argued that inclusion of a bonus in compensation for purposes of determining eligibility for the SBAC should be done based on the taxpayer's elected method of accounting. Four Zero One followed an accrual method of accounting, had deducted the bonus in 2007, and argued that the bonus received in 2008 should be included in compensation for 2007, reducing compensation to $163,996.00 for the 2008 tax year.

The Tax Tribunal applied the definition of "compensation" found in the MBTA at MCL 208.1107(3) and concluded that a bonus constituted "compensation" for the tax year in which the bonus payment is made, irrespective of the taxpayer's method of accounting. Thus, the Tax Tribunal found Four Zero One ineligible for the SBAC.

The Court of Appeals held that, "[c]onsidering MCL 208.1107(3) as a whole and in context, we conclude that the definition of 'compensation' is unambiguous and it is clear that a bonus should be counted as 'compensation' in the year in which the payment of the bonus is made." Therefore, the Court of Appeals upheld the denial of the SBAC.

Warranties and Extended Service Contracts

Often, purchases of tangible personal property include a manufacturer's warranty with the product. Sometimes sellers also offer buyers an optional warranty or a service contract for the product. The sales and use tax treatment of these warranties and service contracts can differ. Following is a brief discussion of various options and their sales/use tax consequences.

Manufacturer Warranty: A manufacturer's warranty is a warranty that is included with a product at the time of purchase. It is subject to sales tax at the time the product is sold, even if separately stated on the invoice. As a consequence, the customer is not charged tax on any tangible personal property later provided to fulfil the warranty, because the warranty was taxed at the time of purchase. Michigan Letter Ruling 89-61.

Extended/Optional Warranty: An extended warranty that is offered as an option and separately stated on an invoice is not subject to sales tax. However, any tangible personal property furnished under terms of this type of warranty is subject to tax. For example, in the case of vehicles, if the manufacturer offers the optional warranty, the dealer will be reimbursed by the manufacturer for the parts. Sales tax will be due on the price the dealer charges the manufacturer. If the dealer offers the optional warranty, use tax is due on the cost of the parts the dealer furnishes. Michigan Letter Ruling 85-17.

Goodwill adjustment policy: Replacement parts provided by a manufacturer for no charge to customers under a "goodwill adjustments policy" under which a manufacturer and its dealers provide parts and repairs after the warranty has expired, are not subject to use tax. The value of the goodwill program is considered to be included in the retail price paid by customer for the property at the time of sale and, therefore, has already been subject to sales tax. General Motors Corp v Dep't of Treasury, 466 Mich 231 (2002).

Customer "Deductible" for Work Under a Warranty

Wear and Tear Charge Under a Manufacturer Warranty. Occasionally there is a charge to the customer, in the form of a deductible, on a specific replacement part for "wear and tear." When the customer is charged in the form of a deductible, the "deductible" will be subject to sales tax. Michigan Letter Ruling 89-61.

Deductible Under an Optional/Extended Warranty: Under an optional warranty, the company providing the warranty is responsible for tax on any parts provided under the warranty. If the warranty company is a third party [not the party providing the repair service] and a customer owes a deductible under the warranty, the servicer can reduce the charge for parts to the warranty company by the deductible to prevent double taxation. Example: Dealer charges $300 for parts, $400 for labor and the customer has a $100 deductible. The third party warranty company pays the dealer $600 and the dealer will collect $100 from the customer. The $600 bill to the warranty company should be allocated $200 for parts and $400 for labor. The $100 received from the customer will be subject to sales tax.

Extended Service Contract: An extended service contract is not a warranty agreement. An extended service contract, e.g. an agreement that covers oil changes and tire rotations, is basically an optional maintenance contract. If the contract is optional and separately itemized, it is not taxable upon sale to a customer. The servicer under the contract, however, must pay tax on any tangible personal property used to fulfill the maintenance contract. Michigan Letter Ruling 88-30.

Getting the Most Out of Your Informal Conference

Taxpayers have the right to appeal adverse decisions of the Department of Treasury.

One of the ways to appeal is an informal conference through the Hearings Division.

The purpose of an informal conference (explained in Mich Admin Rule 205.1010(1)) is to informally discuss the positions of the parties, narrow the contested issues, and present arguments to the Referee to allow the Referee to make an informed recommendation to the Treasurer. This article explains how to get the most out of this tool available to all taxpayers.

The informal conference is designed to be "informal". It is not a judicial proceeding or a contested case proceeding under the Administrative Procedures Act, so Court Rules and formal rules of evidence do not apply; however, all factual testimony given at the informal conference is received with the understanding that it is provided as true and complete.

Rule 205.1010(6) also provides that matters alleged as fact may also be submitted in the form of affidavits. In some cases, the Referee may request that an affidavit be provided after the informal conference, along with other supporting documentation, to give weight to any factual assertions made at the informal conference. The taxpayer is not obligated to provide the requested affidavits and/or documentation, but should understand that if the Referee has asked for such documentation, as the fact-finder the Referee may need that evidence in order to support the testimony received at the informal conference.

However the Rules do not require the Referee to allow additional time after the informal conference for a party to provide further information or documentation. If the Referee does allow additional information or documentation to be provided, it is imperative that the party providing the additional information comply with any dates or deadlines given by the Referee. If a party requests additional time beyond a deadline, that request should be put in writing to the Referee prior to the deadline, with the understanding that the request may or may not be granted. The parties should also understand that the Referee may not consider any additional documentation or information provided after the informal conference that was not discussed at the informal conference, or that is provided after a deadline has passed, unless a prior request for additional time has been made and granted by the Referee.

There is no formal record made of the informal conference. Any party wishing to audio-record the hearing may do so only if they have provided at least seven (7) days written notice prior to the informal conference. See, MCL 205.21(2)(d) and R 205.1010(11).

Although no court reporter is present, it is nonetheless important that the Referee, as the fact-finder, be able to hear everything being said. With that in mind, each party should wait to speak until the other party, or the Referee, has finished speaking, and should not talk over each other. The Referee will generally conduct the informal conference by allowing one side (either the taxpayer or Treasury) to present its position and arguments without interruption from the other side, and then allow the other party the same opportunity. If time allows, and the Referee believes additional dialogue between the parties would be useful, additional informal discussion will be allowed. During the presentation of arguments, and during the informal discussion, the Referee may ask questions. It is important for the parties to listen to the question and make their best effort to answer the question asked. It is also generally more effective in the informal conference setting for the parties to ask questions of the other side in an open ended manner designed to elicit

Informal Conference continued . . .

additional information, rather than in a cross-examination format.

Finally, the parties are expected to conduct themselves with civility and professional courtesy in the informal conference. Personal attacks are never tolerated.

The informal conference rules allow for a party to attend the conference by telephone or in person, or to request that the dispute be reviewed and resolved based on the written record without an informal conference. See, R 205.1010(7) and (8). A party will not be penalized for attending the informal conference by telephone or for requesting that the dispute be reviewed and resolved based on the written record. A party who chooses to have a dispute reviewed and resolved based on the written record should provide a written statement that contains the facts, a discussion of the law, and the legal arguments that the party would have presented at the informal conference. The party must also advise the Referee as early as possible in advance of the informal conference of his or her election to have the dispute reviewed and resolved on the written record. R 205.1010(7).

If a taxpayer has documents to present at the informal conference, and wishes to attend by telephone, the taxpayer should provide the documents at least five (5) days before the informal conference to allow the Referee time to provide the documents to the Treasury representative for review prior to the conference. Contact between the Referee and the parties after the informal conference is limited to contact initiated by the Referee.

Discovery rules do not apply to the informal conference process. If a taxpayer or representatives are not available for the time the informal conference has been scheduled and they do not wish to submit a written statement in lieu of attending the informal conference, they may request an adjournment under Rule 205.1009(5). The adjournment request must be submitted to the Referee in writing and must be received at least 48 hours before the scheduled time. It is in the Referee's discretion to grant a request for adjournment. The Referee will consider the reasonableness of the reasons offered, the timing of the request, as well as other factors relating to fair and efficient tax administration in determining whether to grant or deny an adjournment request. If the request for adjournment is denied, the taxpayer always retains the right to attend via telephone or submit a written statement in support of their position prior to the informal conference.

After the informal conference, the Referee will review the law and the facts, and will write a Recommendation to the Hearings Division Administrator, who is an authorized representative of the Treasurer. R 205.1011(1). The Referee does not make the ultimate decision for Treasury.

The Hearings Division Administrator will review the Recommendation, and can

Informal Conference continued on page 8 . . .

About *Treasury Update*

Treasury Update *is a periodic publication of the Tax Policy Division of the Michigan Department of Treasury.*

It is distributed for general information purposes only and discusses topics of broad applicability. It is not intended to constitute legal, tax or other advice. For information or advice regarding your specific tax situation, please contact your tax professional.

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

Mike Eschelbach,
Director, Tax Policy Bureau
517-373-3210

Lance Wilkinson,
Administrator, Tax Policy Division
517-373-9600

Email address:
Treas_Tax_Policy@michigan.gov

Archives of Treasury Update can be found on the website at **Michigan.gov/Treasury** *under the* ***Reports and Legal Resources*** *tab.*

Informal Conference continued . . .

either accept or reject the Recommendation in whole or in part. R 205.1011(2). If the Hearings Division Administrator rejects the Recommendation, a rebuttal will be written with reasons and authority for the rejection.

Once the Referee submits a Recommendation to the Hearing Division Administrator, the Referee's role in the matter is completed. Neither the taxpayer nor the Department representative will review the Recommendation of the Referee before it is issued. R 205.1011(3). The Hearings Division Administrator will issue a decision and order which is limited to the subject of the informal conference, and which will be the Treasury's final decision on the matter. Per R 205.1011(3), there will not be a rehearing of the decision and order. Appeal rights (to the Michigan Tax Tribunal or to the Court of Claims) in the case of a denied refund are provided with the decision and order. If a final assessment is issued as a result of a decision and order, appeal rights will be included on the final assessment.

A taxpayer who wishes to withdraw his or her request for an informal conference may do so in writing at any time. See MCL 205.21(2)(d). A written withdrawal must be signed by the taxpayer or an authorized representative with authority to enter into agreements on behalf of the taxpayer to be considered a valid withdrawal. If a valid withdrawal is received, the Hearings Division will cancel the informal conference (if one has been scheduled), and a Recommendation indicating that the taxpayer has withdrawn will be prepared.

The Recommendation will include a statement as to whether a final assessment should be issued or whether a refund claim should remain denied. The recommendation will also reference any adjustments have been made by the parties in an attempt to resolve the matter prior to the informal conference, and will include a statement as to any disputed issues that have been resolved by adjustment or concession. A decision and order will be issued pursuant to MCL 205.21(2)(d).

MICHIGAN DEPARTMENT OF TREASURY

Improving Services to Michigan Taxpayers

DID YOU KNOW?

- Treasury has improved Michigan Treasury Online (MTO) and continuously rolls-out enhancements based on user feedback.
  MTO.TREASURY.MICHIGAN.GOV
- We are hosting **OUTREACH EVENTS** throughout the state for business taxpayers to learn about cash-basis audits, MTO updates and more.

All Things Advocate: The Overview

By the Office of the Taxpayer Advocate

As the first of what will become a standing column from the Office of the Taxpayer Advocate, I thought it appropriate to start out by sharing a brief overview of the office.

The Office of the Taxpayer Advocate was originally established in the late 1980s and, as with many State of Michigan functions, it experienced various organizational and structural changes over the past three decades. The one constant has been that the office serves as Treasury's resource of last resort for taxpayers and tax practitioners who have not been able to resolve their issues through Treasury's normal channels. We take a fresh look at each case brought to our attention and work independently within Treasury to ensure taxpayer's rights are protected and Treasury's processes are fairly administered. However, our office is not a substitute for the appeals process. Along with specific account resolution, the office identifies and communicates systemic policy and operational issues that affect multiple taxpayers. One area we have recently expanded is the role of educating taxpayers through outreach to tax practitioners and the Legislature. It is our hope that this will increase compliance through knowledge and education.

The Office of the Taxpayer Advocate consists of eight full-time staff members that specialize in various taxing and non-taxing areas of the department. We are a small office and do not have the resources to function as a call center or an all-purpose help desk. Because of this, we ask those contacting our office to provide detailed information. Requests for assistance on any tax-related case should include:

- the name and telephone number of the individual contacting us
- the taxpayer's name, last four digits of the SSN or full FEIN
- tax type
- tax year involved
- reason for contacting our office.

Individual and business taxpayers who have exhausted all attempts to remedy their situation through Treasury's normal channels may contact the Office of the Taxpayer Advocate by calling 517-636-4759 or emailing taxpayeradvocate@michigan.gov.

Tax practitioners may contact the Office of the Taxpayer Advocate by calling the Tax Practitioner Hotline at 517-373-0616 and leaving a voicemail or by sending a request online through the secured Tax Practitioner Web Services. Please note the hotline and web services are restricted to tax practitioners only.

I hope you've found this helpful.

Regards,
Robin L. Norton
Taxpayer Advocate

Tax Practitioner Hotline & Web Services

In early 2017, the decision was made to restructure the Tax Practitioner Hotline and Web Services. Practitioners calling or submitting web inquiries about business tax questions are no longer transferred out of the Office of the Taxpayer Advocate.

The Hotline options were also modified to allow callers to select three options.

Detailed Web Services instructions are now offered under option #1.

General and taxpayer specific questions about Individual Income Tax can now be left under option #2.

General and business specific questions about CIT, MBT, SBT, and SUW can now be left under option #3.

To reach Treasury's Tax Practitioner Hotline, call 517-373-0616.

For a link to Treasury's Tax Practitioner Web Services, click here.