

INTERNAL POLICY DIRECTIVE 2006-7

September 29, 2006

SINGLE BUSINESS TAX / INCOME TAX IRC § 199 DEDUCTIONS

POLICY ISSUE

1. Whether entities taxed as corporations for federal income tax purposes, including limited liability companies electing to be taxed as corporations, and subject to the Michigan Single Business Tax ("SBT") may take the IRC § 199 deduction for SBT purposes.
2. Whether pass-through entities not taxed as corporations for federal income tax purposes, including partnerships, S corporations, and limited liability companies, subject to the SBT may take the IRC § 199 deduction.

POLICY DETERMINATION

1. SBT taxpayers that are taxable as corporations that qualify for an IRC § 199 deduction on their federal tax return will automatically experience a corresponding reduction in their SBT tax base and SBT liability.
2. SBT taxpayers that are pass-through entities are not entitled to take the IRC § 199 deduction at the entity level, but rather the deduction is taken at the shareholder, member, or partner level for Michigan income tax purposes.

DISCUSSION

Domestic Production Activities Deduction

The American Jobs Creation Act of 2004 added the domestic production activities deduction, which provides a tax benefit for certain domestic production activities. For tax years beginning on or after January 1, 2005, IRC § 199 allows a deduction equal to a specified percentage of the taxpayer's qualified production activities income for the tax year. The specified percentage begins at 3% for 2005-2006, rises to 6% for 2007-2009, and increases to 9% for 2010 and thereafter.

The deduction is available to corporations, individuals, estates, and trusts that are engaged in certain domestic trade or business activities. For pass-through entities, including partnerships, limited liability corporations taxed as partnerships, and S corporations, the deduction is based on the activities of the pass-through entity but is computed at the individual partner, member, or shareholder level. Taxpayers use federal Form 8903 to compute the deduction.

Single Business Tax

The Single Business Tax ("SBT") is levied "upon the adjusted tax base of every person with business activity in this state that is allocated or apportioned to this state." MCL § 208.31. "Adjusted tax base" means the tax base allocated or apportioned to Michigan after application of certain adjustments (MCL §§ 208.23, 208.23b) and exemptions (MCL § 208.35). MCL § 208.31. "Tax base" means business income prior to allocation or apportionment, subject to certain adjustments. MCL § 208.9. "Business income" means federal taxable income. MCL § 208.3. Except that for persons other than corporations, "business income" means that portion

of federal taxable income "derived from business activity." MCL § 208.3. "Federal taxable income" means taxable income as defined in IRC § 63. Federal taxable income is determined under IRC § 63 by subtracting the IRC §199 deduction from gross income. For partnerships and limited liability companies taxed as partnerships, business income also includes "payments and items of income and expense which are attributable to business activity of the partnership and separately reported to the partners." MCL § 208.3. Finally, "person" includes individuals, partnerships, limited partnerships, limited liability companies, and corporations. MCL § 208.6.

Corporations¹

"Business income" for a corporation means federal taxable income. Federal taxable income is calculated by deducting the domestic production activities deduction from gross income. See IRC §§ 63, 199. In other words, for federal corporate return purposes, the domestic production activities deduction (Form 1120, line 25) is used to calculate (and reduce) federal taxable income (Form 1120, line 30). In turn, business income for SBT purposes is reduced. No SBT provision specifically disallows corporations from taking IRC § 199 deductions, nor is there a provision that requires any IRC § 199 deduction to be added back to business income. Thus, corporate SBT taxpayers that qualify for an IRC § 199 deduction on their federal tax return will automatically experience a corresponding reduction in its SBT tax base and SBT liability.

Pass-Through Entities

"Business income," for purposes of pass-through entities, means "that part of federal taxable income derived from business activity." MCL § 208.3. Federal taxable income for pass-through entities is determined under IRC §§ 703 and 1363. Business income includes "payments and items of income and expense which are attributable to business activity of the partnership and separately reported to the partners." MCL § 208.3.

By its express terms, IRC § 199 does not apply at the entity level with regard to pass-through entities and is not included in the federal taxable income of the entity. See IRC § 199(d)(1)(A). Furthermore, IRC § 199 is not an item of income or expense separately stated under IRC § 702(a). See IRC §§ 199, 703, and 1363. Rather, pass-through entities must directly report to shareholders, members, or partners each item of information needed to calculate the domestic production activities deduction at the shareholder, member, or partner level.²

For the forgoing reasons, the domestic production activities deduction is not applicable to pass-through entities for Michigan SBT purposes; rather, the IRC § 199 deduction is taken at the shareholder, member, or partner level for Michigan income tax purposes.

¹ For purposes of this Internal Policy Directive, a limited liability company that elects to be taxed as a corporation for federal income tax purposes is treated as a corporation for SBT purposes. RAB 1999-9.

² "Other pass-thru entit[ies]" referenced in IRC § 199(d)(1)(A) include limited liability companies taxed as partnerships for federal income tax purposes. See Treas. Reg. § 301.7701-1 *et seq.* Similarly, the reference to the application of IRC § 199 for pass-through entities "at the shareholder, partner, or similar level" includes members of a limited liability company taxed as a partnerships for federal income tax purposes.