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STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

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INDIVIDUAL INCOME TAX – FLOW-THROUGH ENTITY WITHHOLDING TAX ISSUES ON COMPOSITE RETURNS

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 2010-8.

The Michigan Income Tax Act ("ITA"), 1967 P.A. 281, was amended in 2003 to allow composite income tax filings[1] and to require flow-through entity withholding.[2] A flow-through entity may file a composite return on behalf of electing nonresident members[3] using procedures described in RAB 2004-1. A flow-through entity with nonresident members must make withholding tax payments to the Department on behalf of the nonresident members[4] in the manner prescribed in the RAB titled "Flow-through Entity Withholding Tax." A member's participation or nonparticipation in a composite filing does not affect mandatory flow-through entity withholding requirements.

This bulletin describes how withholding tax payments are reported and credited on composite returns by fiscal year filers and in tiered entity structures. In addition, this bulletin describes registration requirements for flow-through entities subject to flow-through entity withholding taxes.

ISSUES

1. How does a fiscal year flow-through entity report income and flow-through withholding on composite returns?

[1] 2003 PA 49.
[2] 2003 PA 22.
[3] MCL 206.315(3).
[4] MCL 206.351(2).

2. How is flow-through entity withholding tax reported and credited in a tiered entity structure?

3. Is a separate registration required for flow-through entity withholding?

CONCLUSIONS

1. Flow-through entity withholding tax is always computed and credited on a calendar year basis, even when the flow-through entity is filing its federal return and reporting income to members on a fiscal year basis. This means that income and payments of fiscal year flow-through entities may not match in one or more quarters, and can be reported on different annual year composite returns.

2. An "upper tier" flow-through entity that is a member of another "lower tier" flow-through entity does not report withholding tax payments paid by the lower tier entity on its own composite return when it elects to participate in a composite return filed by the lower tier entity. Conversely, a lower tier entity does not report withholding tax paid on behalf of a nonparticipating upper tier entity on its own composite return.

3. A flow-through entity must register separately for flow-through entity withholding.

LAW & ANALYSIS

<u>Background</u> Prior to the 2003 law changes, composite income tax filings were administratively allowed by the Department, however, there was no flow-through entity withholding. Quarterly estimated payments were made by either members individually or by the flow-through entities on behalf of members participating in composite returns.

After enactment of 2003 PA 22, flow-through entities with nonresident members were required to make withholding tax payments to the Department on the nonresident members' distributive share of Michigan income. These withholding tax requirements replaced the quarterly estimated tax payment requirements. In general, S corporations and partnerships with nonresident members and Michigan sourced distributive or pro-rata share income are now required to file and pay quarterly withholding tax returns that are based on the nonresident partners' or shareholders' estimated share of Michigan income.

The contemporaneous enactment of 2003 P.A. 49 placed in statute the Department's administrative practice of allowing a flow-through entity to file composite income tax returns on behalf of nonresident members. "Nonresident member" and "flow-through entity" are defined in sections 12 of the Michigan Income Tax Act, MCL 206.12. A "flow-through entity" is defined as a "S corporation, partnership, limited partnership, limited liability partnership, or limited liability company," and "nonresident member" is defined as a "nonresident individual, nonresident estate or trust, or a flow-through entity with a nonresident member." The composite filing is in lieu of the nonresident partners or shareholders each filing separate income tax returns, ***and is always due on April 15 of the year following the end of the flow-through entity's tax year***.[5] This due

[5] MCL 206.315(5).

date puts the members that participate in the composite filing on the same footing as the members that file their own Michigan income tax returns.

<u>Fiscal Year Filers</u> A flow-through entity, such as an S corporation or partnership, may elect to file a fiscal year return for federal income tax purposes. A partnership files its federal return on the form 1065, *U.S. Return of Partnership Income*, and an S corporation files its federal return on form 1120S, *U.S. Income Tax Return for an S Corporation*. The partnership or S corporation then reports each members' distributive or pro-rata share of income on the federal schedule K-1, *partner's or shareholder's share of income, deductions, credits, etc*. The K-1 information is reported on the member's own income tax return using the member's own accounting period. For individual flow-through members, the accounting period is generally a calendar tax year.

When a flow-through entity files on a fiscal year basis, and the member files a calendar year return, the member reports the flow-through income on the same calendar year return in which the flow-through entity's fiscal year ends. A flow-through entity with a fiscal year ending ("FYE") September 30, 2007, would report the income that it earned during the 12 month period from October 1, 2006 through September 30, 2007, to its members on a 2007 K-1. The individual members would then report this income on their calendar year 2007 returns. If the flow-through entity files a composite return on behalf of its membership, this income would be reported on a 2007 composite return that is due April 15, 2008. Any income the flow-through entity earned between October 1, 2007 and December 31, 2007, would be reported on that entity's FYE September 30, 2008 return and on the members' 2008 schedule K-1. The members would then include this income on their 2008 calendar year returns, or on a 2008 composite return filed on their behalf.

A flow-though entity with nonresident members is subject to the withholding tax provisions of MCL 351(2). The flow-through entity withholding tax returns and payments are due quarterly on the 20^{th} of the month following the end of each calendar quarter. The calendar year quarters are those quarters ending March 31, June 30, September 30, and December 31. ***While the income reported to the flow-through entity's members is computed on a fiscal year basis, the payments made by the flow-through entity on behalf of its members are reported on a calendar year basis***. Thus, for the flow-through entity with a FYE September 30, 2007, the income from the quarter ending December 31, 2007, is reported on the members' 2008 calendar year federal and Michigan income tax returns, but the payment for that quarter will be reported on the member's 2007 calendar year return. Any discrepancies between income and payments that occur through use of this reporting method can generally be eliminated by crediting overpayments forward on composite returns.

> **Example 1.** Partnership A files a FYE September 30, 2007 federal 1065. All of its income is from Michigan sources, and all of its members are nonresident individuals who elect to participate in A's composite filing. Partnership A had quarterly income and made withholding tax payments according to the following schedule:

Period	Income	Payment
Oct. 1, 2006 – Dec. 31, 2006	$30,000	$1,200
Jan. 1, 2007 – March 31, 2007	$60,000	$2,400
April 1, 2007 – June 30, 2007	$40,000	$1,600
July 1, 2007 – Sept. 30, 2007	$50,000	$2,000
Oct. 1, 2007 – Dec. 31, 2007	$70,000	$2,800

Income from the quarter beginning October 1, 2006 through the quarter ending September 30, 2007 of $180,000 will be reported on the 2007 composite return. Withholding payments from the quarter beginning on January 1, 2007 through the quarter ending December 31, 2007 of $8,800 will be reported on the 2007 composite return. The payment of $1,200 for the quarter ending December 31, 2006 will be reported on the 2006 composite return, and the income of $70,000 from the quarter ending December 31, 2007 will be reported on the 2008 composite return.

Members who do not participate in a composite filing will use this same accounting method to report income and withholding payments on their separate Michigan income tax returns.

Tiered Entities A flow-through entity that has one or more members who are other flow-through entities is categorized as a tiered entity. A typical tiered entity structure consists of a source, or lower tier, flow-through entity, and one or more pass through, or upper tier, entities. In this type of arrangement, the upper tier entity receives income from the lower tier entity that it passes through to its own members.

When a lower tier flow-through entity files a composite return on behalf of its nonresident members, an upper tier flow-through entity may elect to participate in the composite filing, together with the lower tier entity's other nonresident members. If the upper tier entity has no other source of Michigan income, this composite filing will fulfill its Michigan income tax filing requirement. If the upper tier entity's members have no Michigan sourced income, the lower tier's composite filing fulfills their Michigan income tax filing and payment obligations as well.

When the upper tier elects to participate in the lower tier's composite filing, the upper tier's share of income and withholding tax payments from the lower tier entity are reported on the composite return filed by the lower tier. If the upper tier entity has other Michigan sourced income, and files its own composite return on behalf of its own nonresident members, its share of income from the lower tier entity is subtracted on the (upper tier's) composite return. Therefore, the withholding payments made on its behalf by the lower tier entity are ***not*** included on the upper tier entity's composite return ***when it participates in the lower tier's composite filing***.

When the upper tier entity does ***not*** participate in a composite filing made by the lower tier, or the lower tier does not file a composite return, then the upper tier entity reports its income from the lower tier entity, and claims any withholding tax payments made on its behalf by the lower tier entity, on the (upper tier entity's) composite return.[6] The lower tier may ***not*** include

[6] If the upper tier entity does not file a composite return, its members report the income and withholding payments directly on their own Michigan income tax returns.

withholding payments made on behalf of a nonparticipating upper tier entity or any other nonparticipants on its own composite return**.** The upper tier entity will subtract its share of income from the lower tier entity as *income from other partnerships, S corporations, and fiduciaries included in ordinary income* on line 36 of the composite return, but then add back the Michigan portion of the lower tier entity's income as *income attributed to other Michigan partnerships, S corporations, or fiduciaries that have not been reported on another composite return* on line 40 of the composite return. Therefore, the withholding payments made on its behalf by the lower tier entity ***are*** included on the upper tier entity's composite return when it does ***not*** participate in the lower tier's composite filing.

Example 2. Partnership XYZ files a calendar year federal 1065. For 2008, XYZ has income of $180,000, of which $120,000 is sourced to Michigan. Partners X and Y are nonresident individuals, and partner Z is a Michigan S corporation with two nonresident shareholders. Each partner has a 1/3 interest in XYZ. Z has income of $100,000, all sourced to Michigan, in addition to its distributive share of income of $60,000 from XYZ. A and B are each 50% shareholders of Z, and their only Michigan sourced income is their pro-rata income from Z. XYZ makes flow through withholding payments totalling $4,800 for 2008, and Z makes flow-through withholding payments of $4,000 for 2008. XYZ and Z each file 2008 composite returns.

(a) X, Y, and Z all participate in XYZ's 2008 composite filing. A and B participate in Z's 2008 composite filing. The income and withholding on XYZ's 2008 composite return are reported as follows:

Total Income Subject to Apportionment	$180,000
Apportionment percentage	@66.67%
Total Michigan Apportioned Income	$120,000
Less: Exemption Allowance (3 X $3,500.) @ 66.67%	-$7,003
Taxable Income	$112,997
Tax Rate	@4.35%
Tax	$4,915
Flow-Through Withholding	-$4,800
Underpayment	$115

The income and withholding on Z's composite return are reported as follows:

Total Income ($100,000 + $60,000)	$160,000
Less Income from XYZ	-$60,000
Total Income Subject to Apportionment	$100,000
Apportionment percentage	@100%
Total Michigan Apportioned Income	$100,000
Exemption Allowance (2 X $3,500) @ 100%	-$7,000
Taxable Income	$93,000
Tax Rate	@4.35%
Tax	$4,045
Flow-through Withholding	-$4,000

Underpayment	$45

Example 3. Same facts as example 2, except that Z does not participate in XYZ's composite filing. The income and withholding on XYZ's 2008 composite return are reported as follows:

Total Income Subject to Apportionment	$180,000
Apportionment Percentage	@66.67%
Michigan Apportioned Income	$120,000
Less Michigan Income Attributed to Nonparticipants	-$40,000
Participant's Michigan Income	$80,000
Less Exemption Allowance (2 X $3,500) @ 66.67%	-$4,669
Taxable Income	$75,331
Tax Rate	@4.35%
Tax	$3,276
Flow-through Withholding	-$3,200
Underpayment	$76

The income and withholding on Z's composite return are reported as follows:

Total Income ($100,000 + $60,000)	$160,000
Less Income from XYZ	-$60,000
Total Income Subject to Apportionment	$100,000
Apportionment Percentage	@100%
Michigan Apportioned Income	$100,000
Michigan Allocated Income from XYZ (66.67% @ 60,000)	+$40,000
Total Michigan Income	$140,000
Less Exemption Allowance	-$7,000
Taxable Income	$133,000
Tax Rate	@4.35%
Tax	$5,785
Flow-Through Withholding ($4,000 + $1,600)	-$5,600
Underpayment	$185

<u>Non Participating Members</u> In general, income and withholding tax payments for non participating members will not be included on a composite return filed by a flow-through entity. In addition to nonresident members who elect not to participate, non participants would include resident members and members who are not subject to Michigan income tax, such as tax exempt entities and C corporations. Moreover, flow-through entity withholding is ***not*** required for resident members of a flow-through entity or other members that are not subject to Michigan income tax.

<u>Registration</u> 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 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.