

## STATE OF MICHIGAN



JOHN ENGLER, Governor

**DEPARTMENT OF TREASURY**

TREASURY BUILDING, LANSING, MICHIGAN 48922

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**REVENUE ADMINISTRATIVE BULLETIN 1999-9****Approved:** November 29, 1999**EFFECT OF FEDERAL ENTITY CLASSIFICATION ELECTION  
ON MICHIGAN TAXES**

**RAB 99-9.** This bulletin describes the application of federal entity classification election regulations (check-the-box) to Single Business Tax and Individual Income Tax. In addition, it explains how check-the-box affects the Michigan tax reporting of a single member entity that is disregarded as an entity separate from its owner. Finally, this bulletin describes who is a “taxpayer” for Sales, Use, and Withholding Taxes.

**ISSUES**

- I.** Does Michigan conform to federal check-the-box regulations regarding entity classification for Single Business Tax (SBT)?
- II.** Does Michigan conform to check-the-box regulations for individuals, partners, shareholders, or members required to file an individual income tax return?
- III.** How is the election of entity classification made at the state tax level?
- IV.** When a Michigan single member Limited Liability Company (LLC) that elects to be disregarded for federal income tax purposes is owned by an entity without nexus with Michigan, does the owner of the LLC have nexus with Michigan and the requirement to file an SBT return?
- V.** How are apportionment factors determined for a single member entity that elects to be disregarded as an entity for federal income tax purposes?
- VI.** What is the effect of check-the-box regulations on Sales and Use taxes? For example, will a single member LLC who makes retail sales in Michigan be required to register for Sales and Use taxes if it elects to be disregarded as a separate entity at the federal level?
- VII.** What effect does check-the-box have on Michigan income tax withholding?
- VIII.** When is this RAB effective?

## CONCLUSIONS

- I.** Michigan conforms to federal check-the-box regulations [Treas Reg § 301.7701-1 through § 301.7701-3] for SBT purposes. The entity election or default classification for filing the federal income tax return is effective for all components of the SBT return that are related to federal income tax. Further, the federal tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code (IRC) and general principles of tax law. A taxpayer who elects entity classification at the federal level shall file the Michigan SBT return on the same basis and reflect the same tax consequences.

If a single member unincorporated entity is disregarded as an entity separate from its owner (a tax nothing) at the federal level it is treated as a branch, division, or sole proprietor for SBT purposes.

Under Treas Reg §301.7701-3 an unincorporated entity, such as a limited liability company (LLC), having at least two members, may elect to be taxed as a corporation or, by default, is taxed as a partnership at the federal level. For purposes of the Statutory Exemption and Small Business Credit, a member of an LLC is treated as a partner if the LLC is taxed as a partnership.

If an LLC or other unincorporated entity elects to be taxed as a corporation, the members will be considered shareholders for purposes of the statutory exemption. However, a member is not considered a shareholder for purposes of the small business credit because the Single Business Tax Act specifically defines “shareholder” as an owner of stock for purposes of computing the credit. Likewise, an LLC or other unincorporated entity, even if taxed as a corporation, is still eligible for the unincorporated credit allowed by MCL 208.37.

However, since the legal business organization is not changed by check-the-box regulations, use the actual legal organization classification in the section titled “Organization Type” when completing the SBT return. LLCs will use the organization type that specifies both LLC and the classification used for tax purposes. In addition, when filing the SBT return, attach copies of the first four pages of the federal return, which reflect the entity classification for federal tax purposes, and a copy of federal form 8832, *Entity Classification Election*, if filed.

In the case of a disregarded entity, the single member files the return and indicates its legal organization. The member filing the return should attach a statement to the return listing the single member entity(s) included in the return.

- II.** The election of entity classification for federal income tax purposes is effective on the Michigan individual income tax return of the individual, shareholder, partner, or member. This is true whether the taxpayer is a resident or nonresident of Michigan. Michigan’s individual income tax is based on federal adjusted gross income (AGI) which reflects the entity classification of the individual’s business activity. Therefore, the Michigan income tax return must conform to the entity reported on the federal return. No specific

Michigan income tax adjustments are allowed regarding entity classification. A taxpayer is required to attach a copy of federal Schedules C and E, as well as various other federal schedules to the Michigan income tax return.

- III.** No entity classification election is required or allowed at the state level for SBT or Individual Income Tax because Michigan follows the federal election.
- IV.** Under Treas Reg § 301.7701-2, if a single member entity is disregarded for federal income tax purposes, its activities are included as a part of the owner's activities in the respective sole proprietorship, branch, or division of the owner. Therefore, income, deductions, credits, assets and liabilities of a single member entity having nexus with Michigan, who elects to be disregarded as an entity for federal income tax purposes, are deemed to be those of the owner. The owner of the disregarded entity has nexus by virtue of the property and activities of the single member entity. The owner of such an electing single member entity has the same status with Michigan as the single member entity and must file an SBT return. Likewise, if the owner is a flow-through entity, its partners, members, or shareholders who are individuals must file Individual Income Tax returns.
- V.** The property, payroll, and sales (or special formulas for certain businesses) of the combined entities are used to determine the apportionment factors for SBT and Individual Income Tax of a single member entity and its owner if the single member entity is disregarded at the federal reporting level. Inter-entity sales between the single member entity and its owner are disregarded when computing the sales factor.
- VI.** The federal entity classification for federal income tax purposes has no bearing on Sales or Use tax. Any entity making retail sales in Michigan is required to be registered for Sales tax. In the case of a single member LLC who is disregarded as a separate entity for federal tax purposes, the LLC is still a legal entity and is required to register for Sales tax if making retail sales in Michigan. An entity making purchases for use, storage, or consumption in Michigan shall register for consumer's Use tax. An out-of-state disregarded entity liable for sellers Use tax must register as a seller.
- VII.** Any entity, whether recognized or not for federal income tax purposes, who is deemed to be an "employer" under Internal Revenue Code (IRC) section 3401(d) is also an employer for Michigan income tax withholding purposes and is required to be registered for income tax withholding. This may result in the Michigan withholding taxpayer being different from the taxpayer for federal taxes. If the disregarded entity is not required to obtain a federal employer identification number (EIN), the Department will issue a Treasury (TR) number for Michigan income tax withholding. In addition, the Department may, upon request, enter an agreement to allow a single member disregarded entity to file a combined withholding tax return with its owner.
- VIII.** As it applies to the federal check-the-box regulations, this RAB will be considered to be in effect beginning on January 1, 1997, the effective date of the federal regulations.

## LAW AND ANALYSIS

### Federal Law

Effective January 1, 1997, an eligible domestic entity is permitted to elect its entity classification or is classified under the default provisions for federal tax purposes under Treas Reg § 301.7701-1 through § 301.7701-3. These “check-the-box” provisions define an eligible entity as a separate business entity that is not required to be classified as a corporation. The regulations specify that corporations and certain other organizations (*per se* corporations) that are required to be corporations for tax purposes [see 301.7701-3] are not eligible for entity election. However, an unincorporated entity, such as a Limited Liability Company (LLC), having at least two members, may elect to be taxed as a corporation or, by default, is taxed as a partnership at the federal level. Also, a single member eligible entity may elect to be taxed as a corporation or, by default, is not recognized as an entity for federal tax purposes separate from its owner. A single member entity that is disregarded as a separate entity is treated as a sole proprietor, branch, or division of its owner.

Taxpayers not classified by the default provisions make the federal election by filing form 8832, *Entity Classification Election*, at the beginning of the entity’s tax year. A copy of the form is also attached to the federal tax return for that year. A taxpayer may change its entity classification at any time. However, after the initial entity classification is changed, it may not be changed during the next five years, except in certain instances.

A change in entity classification may have federal tax consequences such as a gain recognized by an organization and its owners under the corporate liquidation rules if that organization formerly classified as an association elects to be classified as a partnership.

### Single Business Tax Treatment

The Single Business Tax Act (SBTA) contains the IRC conformity provision at MCL 208.2(2);MSA 7.558(2) which states:

A term used in this act and not defined differently shall have the same meaning as when used in comparable context in the laws of the United States relating to federal income taxes in effect for the tax year unless a different meaning is clearly required. A reference in this act to the internal revenue code includes other provisions of the laws of the United States relating to federal income taxes.

The statute defines the Internal Revenue Code as the “United States internal revenue code of 1986 in effect on January 1, 1999 or, at the option of the taxpayer, in effect for the tax year.” [MCL 208.5(4); MSA 7.558(5)(4)].

A taxpayer under the SBTA is defined as a “person” subject to tax. [MCL 208.10; MSA 7.558(10)]. Person includes all forms of legal entities. [MCL 208.6; MSA 7.558(6)]. A taxpayer’s SBT base begins with “business income”, which is federal taxable income for a

corporation. [MCL 208.3; MSA 7.558(3)]. For a person other than a corporation, business income means federal taxable income derived from business activity. The SBTA states:

"Business income" means federal taxable income, except that for a person other than a corporation it means that part of federal taxable income derived from business activity. For a partnership, 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(3); MSA 7.558(3)(5)].

Further, the SBTA states: "Federal taxable income" means taxable income as defined in section 63 of the internal revenue code. [MCL 208.5; MSA 7.558(5)].

Because the SBT base is computed using federal taxable income, Michigan conforms to federal check-the-box regulations to the extent that business income, additions, and subtractions are taken from the entity's federal return. In addition, the tax consequences of electing entity classification at the federal level are also subject to SBT to the extent included in federal taxable income, additions and subtractions, CAD and recapture, and treatment of the owners or members. The tax treatment of an elective entity change is determined under all relevant provisions of the IRC and general principles of tax law. This ensures that the federal tax consequences of such an election will be the same if the taxpayer had actually taken the steps that are deemed to occur upon entity classification election. Likewise, such tax consequences flow through to the SBT return.

For purposes of computing the Statutory Exemption [MCL 208.35; MSA 7.558(35)] and the Small Business Credit [MCL 208.36; MSA 7.558(36)], a member of an LLC is treated as a partner if the LLC is taxed as a partnership. The SBTA does not define the terms partner and partnership. However, IRC § 761 defines both terms and states in part

For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title [subtitle], a corporation or a trust or estate. (b) Partner. -- For purposes of this subtitle, the term "partner" means a member of a partnership.

The SBT act does define the term "shareholder" for purposes of computing the small business credit. MCL 208.36(1)(d);MSA 7.558(36) states in part: "[a]s used in this section: . . . .shareholder means a person who owns outstanding stock in the business. . . ." Therefore, the term "shareholder" does not include a member of a LLC for the small business credit. A member will, however, be treated as a shareholder for purposes of the statutory exemption. That SBT section does not define the term so the federal treatment of the member is controlling.

### **Individual Income Tax Treatment**

Michigan resident individuals are subject to the Individual Income Tax on all income, subject to certain statutory adjustments. Nonresidents are taxed on Michigan source income including

income from business activity. Because the computation of Michigan taxable income begins with the individual's federal adjusted gross income, any entity classification made under the check-the-box regulations flows through to the individual's Michigan income tax return in the same manner as for federal income tax purposes. A person with business activity in Michigan that is reported as an individual proprietorship, partnership, or S corporation under federal regulation 301.7701 has business income subject to individual income tax.

The Income Tax Act states in part: "It is the intention of this act that the income subject to tax be the same as taxable income as defined and applicable to the subject taxpayer in the internal revenue code, except as otherwise provided in this act." [MCL 206.2(3);MSA 7.557(102)(3)].

Further, MCL 206.30(1); MSA 7.557(130)(1) states: "'Taxable income' means, for a person other than a corporation, estate, or trust, adjusted gross income as defined in the internal revenue code subject to the following adjustments and the adjustments provided in subsections (2) to (4) . "

The Income Tax Act states: "It is the intention of this section that the income subject to tax of every person other than corporations shall be computed in like manner and be the same as provided in the internal revenue code subject to adjustments specifically provided for in this act." MCL 206.51(7); MSA 7.557(151)(7).

MCL 206.51(8); MSA 7.557(151)(8) states:

As used in this section:

- (a) "Person other than a corporation" means a resident or nonresident individual or any of the following:
  - (i) A partner in a partnership as defined in the internal revenue code.
  - (ii) A beneficiary of an estate or a trust as defined in the internal revenue code.
  - (iii) An estate or trust as defined in the internal revenue code.
- (b) "Taxable income" means taxable income as defined in this act subject to the applicable source and attribution rules contained in this act.

A taxpayer with multistate business activity may apportion business income as prescribed in the Income Tax Act: "Any taxpayer having income from business activity which is taxable both within and without this state, other than the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this act." [MCL 206.103; MSA 7.557(1103)].

Business income that is taxable both within and without Michigan is apportioned using the Income Tax Act's statutory three-factor formula of the partnership, S corporation or individual proprietorship. Note, this formula is equally weighted, unlike the SBT apportionment formula.

### **Income Tax Withholding**

The Income Tax Act includes an employer in the definition of taxpayer to the extent that they must withhold and remit Michigan income tax from the compensation paid to employees. Under

the Act, "'Taxpayer' means any person subject to the taxes imposed by this act or any employer required to withhold taxes on salaries and wages." [MCL 206.26; MSA 7.557(126)].

MCL 206.8(3); MSA 7.557(108)(3) further states: "'Employer' means an employer as defined in section 3401(d) of the internal revenue code. Any person required to withhold for federal income tax purposes shall prima facie be deemed an employer."

The withholding statute states that employers who are required to withhold federal taxes must also withhold Michigan income tax:

Every employer in this state required under the provisions of the internal revenue code to withhold a tax on the compensation of an individual, except as otherwise provided, shall deduct and withhold a tax in an amount computed by applying, except as provided by subsection (7), the rate prescribed in section 51 to the remainder of the compensation after deducting therefrom the same proportion of the total amount of personal and dependency exemptions of the individual allowed under this act that the period of time covered by the compensation is of 1 year. The commissioner may prescribe withholding tables that may be used by employers to compute the amount of tax required to be withheld. [MCL 206.351(1); MSA 7.557(1351)(1)].

Therefore, Michigan follows IRC 3401(d) regarding who is the "employer" for income tax withholding purposes. This may result in an employer for Michigan income tax withholding that is different than that for the federal withholding. If the person making sales in Michigan is not required to have a separate federal EIN, the Department will assign a treasury identification (TR) number for the Sales and Use tax account.

### **Sales and Use Tax Treatment**

The check-the-box provisions for federal income tax purposes do not affect entity classification for Sales or Use Tax purposes.

Any person who makes retail sales in Michigan is subject to sales tax. Any person who sells property for use storage or consumption in Michigan is subject to sellers Use tax. Under the Sales Tax Act, person is defined.

"Person" means an individual, firm, partnership, joint venture, association, social club, fraternal organization, municipal or private corporation whether organized for profit or not, company, estate, trust, receiver, trustee, syndicate, the United States, this state, county, or any other group or combination acting as a unit, and includes the plural as well as the singular number, unless the intention to give a more limited meaning is disclosed by the context. [MCL 205.51(a); MSA 7.521(a)].

[e]xcept as provided in section 2a, there is levied upon and there shall be collected from all persons engaged in the business of making sales at retail, as defined in

section 1, an annual tax for the privilege of engaging in that business equal to 6% of the gross proceeds of the business, plus the penalty and interest if applicable as provided by law, less deductions allowed by this act. [MCL 205.52(1); MSA 7.522(1)].

Under the Use Tax Act:

"Person" means an individual, firm, partnership, joint venture, association, social club, fraternal organization, municipal or private corporation whether or not organized for profit, company, estate, trust, receiver, trustee, syndicate, the United States, this state, county, or any other group or combination acting as a unit, and the plural as well as the singular number, unless the intention to give a more limited meaning is disclosed by the context. [MCL 205.92 (a); MSA 7.521(a)].

"Seller" means the person from whom a purchase is made and includes every person selling tangible personal property or services for storage, use, or other consumption in this state. If, in the opinion of the department, it is necessary for the efficient administration of this act to regard a salesperson, representative, peddler, or canvasser as the agent of a dealer, distributor, supervisor, or employer under whom the person operates or from whom he or she obtains tangible personal property or services sold by him or her for storage, use, or other consumption in this state, irrespective of whether or not he or she is making the sales on his or her own behalf or on behalf of the dealer, distributor, supervisor, or employer, the department may so consider him or her, and may consider the dealer, distributor, supervisor, or employer as the seller for the purpose of this act. [MCL 205.92(d); MSA 7.555(2)].

The entity classification election provided by Treas Reg § 301.7701 has no bearing on a person subject to Michigan Sales or Use tax. If the person making sales in Michigan is not required to have a separate federal EIN, the Department will assign a Treasury identification (TR) number for the sales and Use tax account.