

STATE OF MICHIGAN



JOHN ENGLER, Governor

**DEPARTMENT OF TREASURY**

TREASURY BUILDING, LANSING, MICHIGAN 48922  
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**REVENUE ADMINISTRATIVE BULLETIN 2000 - 5**

**Michigan Tax Treatment of Federal Qualified Subchapter S Subsidiary (QSub) Election**

**Approved:** June 19, 2000

**RAB 2000 – 5.** This bulletin describes the effect of a federal Qualified Subchapter S Subsidiary (QSub) election on Michigan taxes. It explains Michigan's conformity with subchapter S of the Internal Revenue Code for Single Business Tax and Individual Income Tax purposes. In addition, this bulletin describes the change in Single Business Tax treatment following the enactment of Public Act 115 of 1999 effective July 14, 1999. Finally, it explains how a QSub election affects who is a "taxpayer" for Sales, Use, and Withholding Taxes.

**ISSUES**

- I. Does Michigan conform to federal QSub treatment for Single Business Tax (SBT)?
- II. How is a business loss deduction that was created on the separate SBT return of an S corporation or its QSub reported on the subsequent single SBT return for the S corporation and its QSub?
- III. Does Michigan conform to federal QSub treatment for shareholders required to file an Individual Income Tax (IIT) return?
- IV. How does a taxpayer make the QSub election at the state tax level?
- V. What effect does a QSub election have on nexus with Michigan for SBT or income tax for the parent or subsidiary?
- VI. How are apportionment factors determined for an S corporation and its QSub?
- VII. What is the effect of QSub treatment on SBT or IIT if an S corporation and its QSub are subject to different SBT base or, SBT or IIT apportionment provisions?
- VIII. What is the effect of a QSub election on Sales and Use taxes? For example, will the Department require a QSub that makes retail sales in Michigan to register for sales tax?
- IX. How does a QSub election affect Michigan income tax withholding?
- X. When is this RAB effective?

## CONCLUSIONS

I. Michigan conforms to the federal QSub election for SBT purposes. Under federal tax provisions, the separate existence of a QSub is ignored. An S corporation and its QSub are deemed to be one corporation and file a single federal income tax return. For SBT purposes, the QSub is also disregarded as an entity and the S corporation and its QSub must file a single return.

Public Act 115 of 1999 amended the Single Business Tax Act (SBTA) effective July 14, 1999 to update the Internal Revenue Code (IRC) reference to that "in effect on January 1, 1999 or, at the option of the taxpayer, in effect for the tax year." [MCL 208.5(5); MSA 7.558(5)]. Formerly, the SBTA referenced the IRC of 1986 in effect on January 1, 1987, which did not include QSub treatment.

A taxpayer makes a federal QSub election by filing a form prescribed by the IRS. [Treas Reg 1.1361-3(a)(2)]. Until the IRS publishes a new QSub election form, taxpayers continue to use form 966, Corporate Dissolution and Liquidation. SBT filers must attach a copy of form 966 or any subsequent federal QSub form to their SBT return for the year the federal election is made or the first year the election is reflected on the SBT return.

II. The S corporation and its QSub must file amended returns combining the activities of both entities for all prior tax years that affect the computation of the aggregate business loss deduction carryover.

III. The election of QSub status for federal income tax purposes is effective on the Michigan individual income tax return of the individual shareholders. 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 QSub election. Therefore, the Michigan income tax return must conform to the QSub election reported on the federal return. No specific Michigan income tax adjustments or allocations are allowed to separate the parent and subsidiary for taxpayers filing under the IRC in effect for tax year 1997 or later.

However, the Income Tax Act conforms to the IRC "in effect on January 1, 1996 or at the option of the taxpayer, in effect for the tax year." [MCL 206.12(2); MSA 7.557(112)(2)]. Since a QSub election was not part of the IRC in effect on January 1, 1996, a taxpayer choosing to use the 1996 code for the Michigan income tax return whose S corporation or subsidiary(s) has business activity in states other than Michigan must separately account for the S corporation and subsidiary(s) and determine apportionment factors based on the separate entities. In addition, a taxpayer opting to use the 1996 IRC must file the entire Michigan income tax return using all provisions of the code in effect on January 1, 1996

IV. No QSub election is required or allowed at the state level for SBT or IIT because Michigan follows the federal election.

V. Under IRC§ 1361(b)(3)(A)(ii) the assets, liabilities, and items of income, deduction, and credit of the QSub are treated as those of the parent S corporation. For SBT and IIT purposes, the parent and/or the subsidiary has nexus with Michigan by virtue of the property and activities of either. The nexus standard for SBT is explained in RAB 1998-1 and differs from the income tax standard that still relies on Public Law 86-272, related constitutional limitations, and case law to determine when a taxpayer is taxable in another state.

VI. 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 an S corporation and its QSub. The apportionment factor computations differ between SBT and IIT. Among other

differences, the IIT factors are equally weighted. Further, the IIT sales factor contains throwback sales, the IIT property factor reflects property owned and used, and foreign sales are Michigan sales unless nexus is established in the destination country. For further details, refer to income tax form MI-1040 H Schedule of Apportionment or SBT form C-8000H Apportionment Formula available at [www.treasury.state.mi.us](http://www.treasury.state.mi.us) [REDACTED] or dialing (517) 241-8730 from a fax phone.

VII. The QSub treatment applies to an S corporation and its QSub(s) even when all are not subject to the same tax base or apportionment calculations. However, the special tax base and apportionment provisions that apply to one, but not all, must be applied on a separate entity basis.

VIII. A QSub election for federal income tax does not affect the subsidiary's liability for sales or use taxes. The sales and use tax statutes specifically define the person liable for such taxes. Any entity making retail sales in Michigan is required to register for sales tax. An entity making purchases for use, storage, or consumption in Michigan shall register for consumer's use tax. An out-of-state QSub is liable for sellers' use tax and must register as a seller if nexus with Michigan exists as described in RAB 99-1. If the QSub is not required to obtain a federal Employer Identification Number (EIN), the Department will issue a Treasury (TR) number to the QSub. Alternatively, the Department may enter into a contract with a QSub and its parent corporation to file a combined Michigan Sales and Use Tax return. Requests for combined filing must be made in writing to:

Michigan Department of Treasury  
Sales, Use and Withholding Taxes Division  
430 W. Allegan St.  
Lansing, MI 48922

IX. Any entity, whether recognized or not for federal income tax purposes, that is deemed to be an "employer" under the Internal Revenue Code, IRC § 3401(d) is also an employer for Michigan income tax withholding purposes and is required to be registered for income tax withholding. This may cause the Michigan taxpayer for withholding tax to be different from the taxpayer for federal taxes. If the QSub is not required to obtain a federal Employer Identification Number (EIN), the Department will issue a Treasury (TR) number to the QSub for withholding reporting. Alternatively, the Department may enter into a contract with a QSub and its parent to file a combined Michigan withholding tax return upon written request to the address above.

X. This RAB is effective January 1, 1997 for Income, Sales, and Use Taxes. However, the Internal Revenue Code reference in the Single Business Tax Act was amended with immediate effect on July 14, 1999. SBT returns for tax years beginning on or after that date are subject to the provisions of this bulletin.

## **LAW AND ANALYSIS**

### **Federal Law**

The Small Business Job Protection Act of 1996 Public Law 104-188, modified § 1361 of the Internal Revenue Code to permit an S corporation to own 80 percent or more of a corporation's stock and to provide an election to treat a wholly owned subsidiary as a qualified subchapter S subsidiary (QSub) for tax years beginning after 1996. According to IRC § 1361(b)(3)(B) an S corporation may elect to treat a domestic corporation that is not ineligible per § 1361(b)(2) and is owned 100% by the S corporation as a QSub. Ineligible corporations include certain financial institutions, insurance companies subject to tax

under subchapter L, corporations making an election under § 936, and Domestic International Sales Corporations.

For federal tax purposes, a QSub is not treated as a separate corporation and all assets, liabilities, and items of income, deduction, and credit of a QSub are treated as assets, liabilities, and such items of the S corporation. [IRC 1361(b)(3)(A)]. The federal tax treatment of a QSub election is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law. A taxpayer who has made a QSub election does not file a separate federal tax return. The parent corporation and its subsidiary file one return; intercompany transactions are disregarded.

Further, Treas Reg § 1.1361-4(a)(2)(i) states in part:

If an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

The IRC contains special rules for banks that must be maintained when QSub treatment is elected. These provisions continue to apply separately to an S corporation or its QSub(s) if one or the other is a bank as if the deemed liquidation had not occurred. [Treas Reg § 1361-4(a)(3)].

The regulations also state that the stock of a QSub shall be disregarded for all federal tax purposes except for purposes of IRC § 1361(b)(3)(B)(i) which requires that 100% of the stock of the subsidiary be owned by the S corporation making the QSub election. [Treas Reg § 1361-4(a)(4)].

The QSub is not required to obtain an Employer Identification Number (EIN). Treas Reg § 301.6109-1(i)(2) states that except as otherwise provided in published guidance, a QSub must use the parent S corporation's EIN for federal tax purposes. Currently, the IRS allows reporting either by the parent or by the QSub itself for federal income tax withholding and other payroll taxes.

### **Single Business Tax Treatment**

The Single Business Tax Act (SBTA) contains the IRC conformity provision 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. [MCL 208.2(2); MSA 7.558(2)].

The statute defines 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)].

The SBTA defines taxpayer as a "person" liable for the tax. [MCL 208.10; MSA 7.558(10)]. Person includes all forms of business and 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 7.559(3)]. 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)].

The federal taxable income of an S corporation and its QSub is determined for the single business entity, which includes the income and deductions of both. Michigan follows the federal QSub treatment because the SBTA conforms to the IRC definitions, including federal taxable income, unless the terms are specifically addressed in the SBTA. Therefore, a subsidiary disregarded as an entity for federal income tax purposes is also disregarded for SBT filing. The federal tax consequences of a QSub election flow through to the SBT return.

However, the SBTA provides specific tax base provisions for insurance companies, financial organizations, and nonprofit entities. There are special apportionment provisions for insurance companies, financial organizations and transportation companies. Further, certain nonprofit organizations or activities are exempt from the tax. If an S corporation and its QSub(s) are subject to different tax base provisions, apportionment calculations, or exemptions, the specific SBT provisions must be applied separately to the parent and the subsidiary. This ensures that QSub SBT treatment is compatible with the special formulas or exemptions.

### **EXAMPLE**

S corporation, X, is a bank that owns Y, a corporation that is not a bank or financial organization. X makes a federal election to treat Y as a QSub. X must compute its SBT base under MCL 208.21 and Y's tax base under MCL 208.9. The financial organization apportionment calculation applies to X while the provisions under MCL 208.46- 208.53 apply to Y. This is consistent with federal treatment of special IRC sections and maintains the specific provisions of the SBTA.

### **Individual Income Tax Treatment**

Michigan resident individuals are subject to 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, a QSub election flows through to the individual's Michigan income tax return in the same manner as for federal income tax purposes. A person with Michigan business activity from an S corporation that is reported under IRC § 1366 has business income subject to individual income tax.

The Income Tax Act states: "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)].

The act further provides: " '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).... "[MCL 206.30(1); MSA 7.557(130)].

According to MCL 206.51(7) and (8); MSA 7.557(151):

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.

As used in this section and sections 51b, 51c, 51d, and 51e: 'Person other than a corporation' means a resident or nonresident individual or any of the following: ...

"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 multi-state 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)]. The jurisdictional standard for determining taxability in another state is based on Public Law 86-272, not the standard recently established for SBT. Generally, a business must go beyond mere solicitation of sales in order to be subject to a net income tax. Therefore, depending on the scope of activities in Michigan, some of which are protected by federal law, a shareholder may not be required to file an income tax return while the S corporation is required to file an SBT return.

Business income that is taxable both within and without Michigan is apportioned using the Income Tax Act's statutory three-factor formula of the S corporation. When an S corporation makes a QSub election, the apportionment factors are the property, payroll, and sales of the aggregated S corporation and its QSub. Again, major differences exist between the computation of apportionment factors for SBT and income tax. As stated in Conclusion VI, the factors for income tax are weighted evenly and reflect several other differences from SBT apportionment factors.

A taxpayer may file the Michigan income tax return under the IRC in effect on January 1, 1996. However, the IRC in effect on January 1, 1996 did not provide for QSub treatment. A taxpayer who has business activity from an S corporation and its QSub that is taxable in other states as well as Michigan, must account for the business income from the S corporation and its QSub separately if filing under the 1996 code. The authority to require separate accounting is found at MCL 206.195; MSA 7.558(1195) which states in part:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) Separate accounting:....

In addition, a taxpayer opting to use the 1996 IRC must file the entire Michigan income tax return using all provisions of the code in effect on January 1, 1996.

### **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 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(26)].

The statute 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." [MCL 208.8; MSA 7.557(108)].

"Employer" is defined at IRC § 3401(d) as:

the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such service, the term 'employer' (except for purposes of subsection (a)) means the person having control of the payment of such wages....

Any employer that must withhold tax at the federal level 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; MSA 7.557(1351)].

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 from that for the federal withholding. If the person deemed to be the employer for Michigan income tax is not required to have a federal Employer Identification Number (EIN), the Department will assign a Treasury identification (TR) number for the withholding account. Alternatively, an S corporation and its QSub may enter into a contract to file a combined withholding tax return. Contact the Sales, Use, and Withholding Taxes Division as stated in conclusion VIII for further information.

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

A QSub election for federal income tax purposes does not affect a taxpayer's status for sales or use tax purposes. An S corporation and its QSub are treated as separate entities and must each report their respective tax obligations.

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 as:

"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; MSA 7.521].

Any person making retail sales is subject to sales tax:

Except 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; MSA 7.522].

Under the Use Tax Act:

(a) "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.

(d) "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; MSA 7.555(2)].

The QSub election provided by IRC § 1361 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. Alternatively, an S corporation and its QSub may enter into a contract to file a combined sales and use tax return. Contact the Sales, Use, and Withholding taxes division as stated in Conclusion VIII for further information.