

NOTICE REGARDING THE IMPLEMENTATION OF THE MICHIGAN FLOW-THROUGH ENTITY TAX

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This notice provides an overview of the provisions of the Michigan flow-through entity tax as recently enacted by 2021 PA 135 and includes special instructions related to the retroactive implementation of that tax.

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¹ In an update published January 26, 2022, Sections I.B., I.D.a., I.E., and II.A.a. as they relate to limitations on the member credit have been corrected to refer to the fifteenth day of the third month after the tax year as the date by which flow-through entity tax payments will be eligible for the credit for a particular tax year. The previous version erroneously named the due date of the annual return as the cutoff. Additionally, the election instructions in Section I.B. have been modified to clarify the irrevocable three-year election for 2021, and the amount of payment required to make a valid election into the tax. In an update published April 5, 2022, the example in Section I.E. was revised as it relates to the limitation addressed in the January 26, 2022 update (see item 4 of the example). The example was further revised to use the appropriate tax base starting point, Business Income rather than Federal Taxable Income. Lastly, that update clarified in Section II.E. the distinction between a flow-through entity tax return and a composite individual income tax return, and the need for both returns under certain circumstances. In a third update published April 14, 2023, Section 1.D.a. was revised to clarify that a taxpayer must apply for an extension of time to file the annual return, even if the taxpayer was granted an extension on their federal return. The application is required under MCL 206.833(3). In a fourth update published April 21, 2023, footnote 27 was updated to provide a link to RAB 2022-24, which replaced RAB 2005-3. Footnote 44 was updated to reflect the current website link.

- B. What adjustments are necessary on the member return for taxes paid by the flow-through entity?**
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III. Questions

I. Overview of the Flow-Through Entity Tax

2021 PA 135 introduces Chapter 20 within Part 4 of the Income Tax Act² to create and levy a flow-through entity tax on electing flow-through entities with business activity in Michigan, effective January 1, 2021. Generally, the flow-through entity tax allows a flow-through entity to elect to pay tax on certain income at the individual income tax rate, with members of that entity eligible to receive a refundable income tax credit equal to the tax previously paid on that income by the flow-through entity. Though the flow-through entity effectively pays tax that would otherwise be paid by its members, it does not eliminate any of the reporting or return filing requirements of those members under Part 1 or Part 2 of the Income Tax Act. Thus, the Michigan flow-through entity tax requires the reporting of complementary entity-level and member-level adjustments to fulfill the scope and intended purpose of ensuring that tax is paid only once on income in Michigan.

A. Who is eligible to pay the flow-through entity tax?

The flow-through entity tax is levied and imposed on certain electing flow-through entities with business activity in Michigan. For this purpose, a “flow-through entity” is defined as “an S corporation or a partnership under the internal revenue code for federal income tax purposes.”³ As used in that context, the term “S corporation” refers to any person that has made the election to be an “S Corporation” as provided under the Internal Revenue Code (IRC)⁴ whereas a “partnership” refers to any entity that is required to or has elected to file as a partnership for federal income tax purposes.⁵ Based on these definitions, the following types of common flow-through entities may elect to pay the flow-through entity tax in Michigan:

1. Limited liability companies (LLCs) that file federal income tax returns as partnerships;
2. Partnerships, including limited partnerships, limited liability partnerships, and general partnerships; and

² MCL 206.801 *et seq.*

³ MCL 206.805(3).

⁴ MCL 206.807(4).

⁵ MCL 206.807(1).

3. S Corporations.

However, certain types of flow-through entities are specifically precluded from paying the Michigan flow-through entity tax, including the following:

1. Publicly traded partnerships as defined under IRC 7704;
2. Flow-through entities subject to the financial institutions tax under Chapter 13 of Part 2 of the Income Tax Act;
3. Entities that are disregarded for federal income tax purposes, such as single member LLCs; and
4. LLCs that file federal income tax returns as corporations.

Entities that are not flow-through entities — such as sole proprietorships or C corporations — are not eligible to pay the flow-through entity tax.

B. How do flow-through entities make an election to pay the flow-through entity tax?

Only entities that affirmatively elect to file a return and pay the tax are subject to the flow-through entity tax. The election must be made by submitting an electronic payment to the Department through the procedures specified in Section II.G of this Notice. Any other manner of making the election – including, for example, the submission of a written election statement or a payment outside of [Michigan Treasury Online \(MTO\)](#) – is not a valid election. For the election to be timely, the payment must be received by the fifteenth day of the third month of the flow-through entity's tax year. Although special rules apply for the initial implementation year, calendar year filers will ordinarily be required to make an election by March 15 of the tax year.⁶ An election made by a flow-through entity is effective for the tax year in which the election is made and for each of the next two successive tax years (i.e., three years total) and, once made, is irrevocable. An election payment must specify the initial tax year of the flow-through entity for which the election is being made.

Special Instruction for 2021. For flow-through entities with calendar or fiscal tax years beginning in 2021, the flow-through entity tax election may be made through April 15, 2022. Any election made through April 15, 2022, for tax year 2021 will be irrevocable for that tax year, plus the next two successive tax years. Flow-through entities can generally make the election for tax year 2021 by specifying a payment for the 2021 tax year that includes the combined amount of any unpaid quarterly estimated payments due for tax year 2021. Any flow-through entity electing after the due date of the flow-through entity tax annual return (March 31, 2022, for calendar year filers) should immediately file the return and include payment of the tax due. For entities electing after March 31, 2022, interest accruing from the initial due date of the return will apply; however, penalty will not be levied for the late filing of the return or payment of the tax. Any election made after April 15, 2022, will not be accepted as a valid election for that tax year.

⁶ MCL 206.813.

Special Instruction for 2022. A calendar year flow-through entity that wants to make an irrevocable election for three tax years beginning with the 2022 tax year must do so no later than March 15, 2022. For any tax year beginning in 2022, elections must be made by submitting a payment through MTO. That payment – which may be either a nominal or greater amount, such as the first quarter estimated payment due on April 15, 2022 - must be designated as applicable to the 2022 tax year.

C. How is tax on an electing flow-through entity calculated?

Flow-through entities that make the election are subject to the flow-through entity tax, which is levied at the same rate levied on individuals for the same tax year under Section 51 of the Income Tax Act (i.e., 4.25% for tax year 2021).⁷ The tax is levied only on the Michigan portion of the positive “business income tax base” attributable to direct members of an electing flow-through entity that are individuals, fiduciaries (i.e., estates or trusts), or other flow-through entities. Any portion of the business income tax base attributable to direct members that are insurance companies, financial institutions, or C corporations is not subject to the flow-through entity tax. Electing flow-through entities must therefore calculate the Michigan portion of the business income tax base before adjusting for the portion that is taxable or nontaxable based on attribution to their members.⁸

a. Determining the Business Income Tax Base

The starting point for the computation of the “business income tax base” is the flow-through entity’s “business income,” which includes “federal taxable income” and any payments and items of income and expense that are attributable to business activity of the flow-through entity and separately reported to its members.⁹ For most flow-through entities, “federal taxable income” refers to taxable income as defined in IRC 63.¹⁰ However, S Corporations do not have federal taxable income as defined under that section¹¹ and are therefore treated as corporations for the sole purpose of computing the business income tax base under the flow-through entity tax.¹² Thus, the starting point of the flow-through entity tax generally begins with amounts determined and reported by the entity for federal income tax purposes.

Once determined, the “federal taxable income” of a flow-through entity is subject to certain specific statutory adjustments. These adjustments, which must be performed prior to the allocation or apportionment of the business income tax base, generally mirror those adjustments required of individuals in computing taxable income under

⁷ MCL 206.51.

⁸ Cf. MCL 206.815(5) (allowing the Department to require taxpayers to identify all members).

⁹ MCL 206.805(1).

¹⁰ The definition of federal taxable income excludes from the computation any deductions described at 703(a)(2), which generally refers to the deduction for a personal exemption, the charitable contribution deduction, the net operating loss deduction, and others. See IRC 703(a)(2).

¹¹ *TMW Enterprises Inc v Dep’t of Treasury*, 297 Mich App 590 (2012).

¹² MCL 206.805(1).

Section 30 of the Income Tax Act.¹³ These include adjustments for the following items to the extent reflected in federal taxable income of that entity¹⁴:

1. Interest income and dividends derived from obligations or securities of states other than Michigan;
2. Income and losses derived from the sale or exchange of certain obligations of the US government;
3. Charitable contributions;
4. Taxes on or measured by net income, including the Michigan flow-through entity tax;
5. Guaranteed payments for services rendered by a member who is an individual;
6. Tax refunds received under the city income tax and flow-through entity tax; and
7. Income from and expenses of producing oil and gas.

Special additional adjustments may be required when computing the tax base of an entity within a tiered structure (i.e., a structure in which a flow-through entity is owned by one or more other flow-through entities). In a tiered structure, any net positive business income attributable to any flow-through entity that elected to pay the tax for the same tax year must be deducted from the business income tax base.¹⁵ In other words, only positive business income attributable to *non-electing* flow-through entities will be included in the business income tax base of its members, which, through various return-level adjustments, is added back into the business income tax base of the reporting entity *after* apportionment and in accordance with that non-electing flow-through entity's own Michigan business activity.¹⁶ The same adjustments, however, are not required when the business income tax base of an entity in a tiered structure is negative (i.e., less than zero). In these cases, the negative business income tax of a flow-through entity remains includable in the business income tax base of its members, even if the loss-generating flow-through entity elected to pay the flow-through entity tax.¹⁷ Electing flow-through entities in a tiered structure must make the above adjustments to the business income tax base, if applicable, and are not permitted to claim any credit for flow-through entity tax paid by any other flow-through entity.¹⁸

Finally, after making all required adjustments, the flow-through entity tax is levied only on the positive business income tax base of an electing entity. If the business income tax base is less than zero, then no tax is due in that year. While a negative business income tax base is includable in the business income tax base of any members that are

¹³ See MCL 206.30.

¹⁴ MCL 206.815(2).

¹⁵ MCL 206.815(2)(h) and (3).

¹⁶ MCL 206.815(4), 206.817(2).

¹⁷ MCL 206.815(1).

¹⁸ MCL 206.819.

flow-through entities, it may not be used to offset the positive business income tax base in any prior or future tax year. That is, the flow-through entity tax does not allow for the carryback or carryforward of losses in a way that is comparable to the business loss provisions of the corporate income tax¹⁹ or the net operating loss provisions of the individual income tax.²⁰

b. Apportionment of the Business Income Tax Base

After completing the statutory adjustments described in Section I.C.a. of this notice, and *before* adding back any positive business income allocated or apportioned to Michigan from non-electing flow-through entities, the business income tax base of the flow-through entity is subject to allocation and apportionment. The Michigan portion of the business income tax base is determined using the allocation and apportionment provisions of Chapter 3 of Part 1 of the Income Tax Act.²¹ In this regard, the business income tax base of the flow-through entity is apportioned to Michigan using a sales²² factor that is based on the ratio of sales sourced to Michigan to total sales everywhere.²³ In determining the sales factor, sales of tangible personal property are typically sourced to the state where the property is delivered to the purchaser²⁴ whereas sales other than sales of tangible personal property are sourced based on the location of the relevant income-producing activity.²⁵ Most importantly, the apportionment rules for flow-through entities are the same rules that apply to business income reported by individual members under Part 1 of the Income Tax Act. The information used to apportion the business income tax base under the flow-through entity tax should therefore be the same information reported by many flow-through entities to its individual members to determine business income taxable in Michigan.

D. What are the filing and payment deadlines under the flow-through entity tax?

The flow-through entity tax establishes certain deadlines for the payment of quarterly estimated taxes and the filing of annual tax returns. Because the flow-through entity tax is administered pursuant to the general provisions of the Revenue Act, MCL 205.1 *et seq.*,²⁶ flow-through entities that fail to file returns or fail to pay tax as required under the flow-through entity tax are subject to penalty and interest.²⁷

¹⁹ MCL 206.623(4).

²⁰ MCL 206.30(1)(n).

²¹ MCL 206.817(1).

²² “Sales” is defined as “all gross receipts of the taxpayer not allocated under Sections 110 to 114 [of the Income Tax Act].” MCL 206.20(1).

²³ MCL 206.121.

²⁴ MCL 206.122.

²⁵ MCL 206.123.

²⁶ MCL 206.841(1).

²⁷ For more information, see [RAB 2022-24](#).

a. *Annual return filing and payment due dates*²⁸

The annual flow-through entity tax return is required to be filed by the last day of the third month after the end of the taxpayer's tax year (March 31 for calendar year filers). An annual return must be filed by all electing flow-through entities – there are no *de minimis* liability thresholds for return filing purposes (i.e., an annual liability of \$100 or less),²⁹ and an annual return is required even if liability was paid in full through estimated payments. The date set for filing the annual return may be extended for an additional 6 months (i.e., until September 30 for calendar year filers) upon application by the taxpayer and payment of the estimated tax liability. Taxpayers may apply by the initial due date, either for good cause shown or on the basis that the taxpayer has been granted an extension of time to file the federal income tax return for that year. MCL 206.833(2) and (3). Although a valid extension extends the time to file the return, it does not extend the time to pay the tax. A flow-through entity must pay, by the initial due date of the annual return, its estimated tax liability unpaid for the tax year covered by an extension. Interest and, if applicable, penalty, will accrue from the initial due date of the return until the tax is paid.

However, any payments toward a tax year's tax liability that are made after the 15th day of the third month after the tax year (March 15 for calendar year filers) will not qualify for a member credit for that same tax year. Instead, those payments will be reported as credits eligible to be claimed for members' immediately succeeding tax year. See Section I.E. for more information on reporting member credits.

Special instruction for 2021. The due date of the flow-through entity tax return for calendar year 2021 is March 31, 2022. As of the publication date of this notice, returns and instructions for the implementation of the flow-through entity tax are being developed and, once available, will be accessible on Treasury's MTO website. The return and any payment toward that return must be filed through MTO.

Because the enactment of the legislation was not expected until the end of the 2021 year, such that significant delays were anticipated in the processing of returns for this initial tax year, the statute provides that, for the tax year 2021 only, any refund reflected in an annual return under Part 4 of the Income Tax Act will not accrue interest.³⁰

b. *Estimated tax payments*³¹

Flow-through entities that elect to pay the flow-through entity tax are required to make estimated payments each year that their annual tax liability is reasonably expected to exceed \$800.³² For calendar year filers, the estimates must generally be made in equal installments on or before April 15, June 15, September 15, and January 15. For fiscal year filers, the estimates must be made in equal installments on dates that correspond to the due dates in the calendar year. Taxpayers are subject to penalty and interest for

²⁸ MCL 206.833.

²⁹ MCL 206.833(1).

³⁰ MCL 206.837.

³¹ MCL 206.831.

³² MCL 206.831(1).

failure to pay estimated payments as required under the Revenue Act; however, for tax year 2022, penalty and interest will not be charged if the preceding year's liability was \$20,000 or less and the taxpayer submitted 4 equal installments, the sum of which equals the immediately preceding year's liability.

Special Instruction for 2021. Because the flow-through entity tax is retroactive for tax year 2021, certain estimated payments otherwise due throughout 2021 may not have been made. Penalty and interest will not be levied on any quarterly estimated tax return or payment that was due prior to the enactment of the tax.³³ **Flow-through entities that elected to pay the flow-through entity tax before January 18, 2022, should include any unpaid estimates with the next quarterly estimated payment due. Entities that have not elected to pay the flow-through entity tax as of January 18, 2022, should remit any unpaid estimated payments when making a timely election to pay the tax.** For example, calendar year filers that have made the election before January 18, 2022, should include the estimates previously due from the first, second, and third quarters with the fourth quarter estimated tax payment due on January 18, 2022.

Some flow-through entities may have previously made quarterly estimated tax payments for purposes of a Composite Individual Income Tax Return (Form 807). Any estimated payments made by a flow-through entity for a composite return will not be treated as estimated payments for purposes of the flow-through entity tax and will accordingly neither satisfy the entity's estimated tax obligations nor constitute an election under the flow-through entity tax. Those flow-through entities must separately remit the quarterly estimated payment(s) required under the flow-through entity tax.

E. What are the relevant reporting requirements for flow-through entities?

In addition to any federal income tax reporting requirements, flow-through entities are required to report to their members certain information about the flow-through entity tax to ensure that member-level return adjustments can be reported accurately (see Section II.A – C of this notice).³⁴ Therefore, on or before the due date of the flow-through entity's annual return each year, the flow-through entity must separately report the following information to each member:

1. Information regarding the allocation and apportionment of the business income tax base and the allocation and apportionment of income subject to tax under Part 1 (i.e., the individual income tax) or Part 2 (i.e., the corporate income tax), as applicable, of the Income Tax Act;³⁵
2. The member's allocable share of the reporting entity's taxes on or measured by net income, including the Michigan flow-through entity

³³ See MCL 205.28(1)(e); MCL 205.30.

³⁴ MCL 206.839(1).

³⁵ Generally, the allocation or apportionment information reported about the flow-through entity business income tax base will be the same as the allocation or apportionment information reported about member income subject to tax under Part 1. For information regarding allocation and apportionment under Part 2 of the Income Tax Act, see Chapter 14 of Part 2 of the Act, MCL 206.661 *et seq.*

tax, that was required to be added back in computing the flow-through entity's business income tax base,³⁶

3. The member's share of the reporting flow-through entity's refund of Michigan flow-through entity tax received during the tax year, if applicable;³⁷
4. The member's share of the following tax amounts, reported separately:³⁸
 - a. The tax imposed under the Michigan flow-through entity tax for the tax year and paid by the fifteenth day of the third month after the end of the tax year;
 - b. The Michigan flow-through entity tax imposed for any prior tax year that was paid in the current tax year excluding any amount reported under 4.a for the previous tax year; and
 - c. The Michigan flow-through entity tax allocated to the reporting flow-through entity under 4.a or 4.b by other flow-through entities with tax years ending on or within the reporting flow-through entity's tax year.

In determining a member's share of the tax items in #4 above, a flow-through entity must base those amounts on the member's share of the income or gain generating the flow-through entity tax that are included in the member's business income. For example, if a member recognizes income, expenses, gains, or losses in proportions other than pro rata based on ownership percentage, the tax allocated to that member must be equal to that percentage.

Example: Flow-through entity FTE is owned by two individuals, X and Y, each with 50% profit/loss share. All are calendar year taxpayers. FTE estimates it will owe \$2,000 in Michigan flow-through entity tax and pays that amount during Year 1 (Y1). On its federal return for Y1, FTE deducts \$2,000 of state tax paid from its total income of \$50,000, arriving at federal ordinary business income in the amount of \$48,000. FTE separately reports distributive share of \$24,000 each to X and Y.

FTE calculates its taxes as follows for Year 1:

FTE Flow-through Tax Return	
Business Income	48,000
Addition: Flow-through entity taxes deducted	2,000
Business Income Tax Base before apportionment	50,000

³⁶ See Section III.B. for discussion on how this information will be used by certain members to report the addition of Michigan flow-through entity taxes paid and deducted by the reporting entity.

³⁷ See Section III.C for discussion on how this information will be used by certain members to report the deduction for their share of refunds of Michigan flow-through entity taxes.

³⁸ See Section III.A for discussion on how this information will be used by certain members as a credit on their return, as well important limitations about the taxes that must be reported to those members.

MI Apportionment Factor	80%
Business Income Tax Base	40,000
Flow-through entity tax due @ 4.25%	1,700
Estimated Tax Payments	(2,000)
Refund	300

In addition to the information required to be reported on Federal Schedule K-1, FTE must report the following to each of its members, X and Y:

1. The apportionment information used to determine the flow-through entity tax, 800,000 Michigan sales over 1,000,000 total sales = 80%.
2. The share of income taxes deducted on FTE's Y1 federal return, \$1,000 per member.
3. The share of refunds of Michigan flow-through entity tax received in Y1, \$0 per member.³⁹
4. For purposes of the members' refundable credits, the share of Y1 tax imposed on FTE and paid by the 15th day of the 3rd month after FTE's Y1 year end, \$850 per member.

Moreover, to allow members to accurately report information in a tiered structure, a flow-through entity must report its members' allocable share of any of the above items that are allocated to that flow-through entity by any other flow-through entity. For example, if FTE A receives an allocable share of a credit for tax paid by FTE B, FTE A must report to each of its members their share of the credit paid by FTE B.⁴⁰ More importantly, these specific reporting requirements apply to both electing and non-electing flow-through entities within a tiered structure in order to allow the ultimate member to claim the credit and make any return adjustments as necessary.

In this regard, there are no statutory requirements related to the form by which this information must be communicated to members of the flow-through entity. Flow-through entities may accordingly provide the required information to its members in any reasonable manner, including as separate statements or as notes attached to the Federal Schedule K-1.

Special Instruction for 2021. The information required to be reported to members under this section may be reported to members of the flow-through entity in any reasonable manner, including as notes or statements submitted with the Federal Schedule K-1.

³⁹ The \$150 refund FTE received in Y2 will be reported as Y2 information.

⁴⁰ Electing flow-through entities in a tiered structure must deduct income received from another electing flow-through entity and are not eligible to claim a credit for Michigan flow-through entity taxes paid by any other electing entity. See Section II.C.a of this notice for more information about computing the business income tax base in a tiered structure.

F. For which tax year is the flow-through entity tax effective?

The flow-through entity tax is retroactive to tax years beginning on and after January 1, 2021. The tax will remain in effect for all tax years beginning after January 1, 2021; however, the continued levy of the tax is contingent upon the existence of the federal state and local tax (SALT) deduction limitation codified within IRC 164(b)(6)(B). The flow-through entity tax is only effective for tax years of a flow-through entity ending with or within a federal taxable year for which the SALT deduction limitation under IRC 164(b)(6)(B) is in effect for individuals. If the SALT deduction limitation is not in effect for a federal taxable year, then the flow-through entity tax will not be levied for that flow-through entity tax year ending with or within that federal taxable year, regardless of any election to pay the tax. In the event this provision is triggered, additional guidance and instruction will be provided by the Department.

Special Instruction for 2021. As of the date of drafting this notice, discussions related to potential changes to the SALT deduction remain ongoing at the federal level. The Department will monitor any relevant changes to the SALT deduction limitation and issue any additional instruction, if necessary, on the Department's website.

G. In what formats can an electing flow-through entity file its annual return? What methods can be used to make estimated or annual tax payments?

All payments and returns required under the flow-through entity tax are required to be submitted electronically through Michigan Treasury Online (MTO), located at <https://mto.treasury.michigan.gov/>. Payments submitted outside of MTO will neither be accepted⁴¹ nor be regarded as a valid election into the flow-through entity tax.⁴² Similarly, returns submitted outside of MTO will not be accepted.⁴³ The Michigan Treasury Online Help Center is available for any questions related to accessing and using MTO.⁴⁴

II. The Flow-through Entity Tax and Member Returns

The flow-through entity tax is levied on the Michigan portion of the positive business income tax base of an electing flow-through entity, which generally correlates to the business income attributed to members that will be taxed in Michigan. Based upon the calculation and payment of the flow-through entity tax, there are certain credits and adjustments that must be communicated to, and thereafter reported on the respective Michigan income tax returns of, an electing flow-through entity's members. Together, these components are designed to generally collect the same amount of income tax under the flow-through entity tax as would otherwise have been collected from members of the flow-through entity.

⁴¹ MCL 206.841(6).

⁴² MCL 206.813.

⁴³ MCL 206.833(1).

⁴⁴ <https://www.michigan.gov/taxes/business-taxes/mto>

A. What is the refundable credit available to members of an electing flow-through entity?

a. General Information About the Credit

PA 135 amends Part 1⁴⁵ and Part 2⁴⁶ of the Income Tax Act to create a refundable credit for certain members of an electing flow-through entity, including individuals, fiduciaries, corporations, insurance companies, and financial institutions. The credit is comprised of three components that must be reported each year to members of a flow-through entity:⁴⁷

1. The member's share of the Michigan flow-through entity taxes imposed on the flow-through entity for the tax year that ends with or within the member's same tax year and paid by the **fifteenth** day of the third month after the end of the flow-through entity's tax year;
2. The member's share of any Michigan flow-through entity taxes imposed in a prior year that are paid in the flow-through entity's current tax year that ends with or within that member's same tax year, excluding any amount reported under 1 for the previous tax year; and
3. The member's share of any flow-through entity taxes paid that are allocated to the reporting flow-through entity by other flow-through entities with tax years ending on or within the reporting flow-through entity's tax year.

Based on these provisions, the amount eligible to be claimed for a credit is limited in two critical respects. First, the refundable credit is limited to the member's allocable share of tax *imposed* on the flow-through entity under the flow-through entity tax.⁴⁸ As such, the credit is limited to the tax levied on the business income tax base of the flow-through entity, after allocation and apportionment to Michigan and as otherwise determined under the relevant provisions of the flow-through entity tax. Overpayments of the flow-through entity tax, including any overpayments of the quarterly estimated tax, will therefore not generate larger credits for members and will instead be refunded to the flow-through entity that made overpayments. Likewise, any portion of a payment from a flow-through entity that is applicable to penalty or interest is not eligible to be claimed as a credit.

Example:

FTE made timely estimated payments of \$1,000, but FTE's annual flow-through entity tax liability is only \$900. FTE will therefore claim a \$100 refund on its annual return, which will be issued to the FTE upon the processing of that return. The credit available to members of the FTE will be limited to their allocable share of the \$900 tax levied on the FTE.

⁴⁵ MCL 206.254.

⁴⁶ MCL 206.675.

⁴⁷ MCL 206.839(1)(d).

⁴⁸ MCL 206.254, 206.675, and 206.839(1)(d).

Second, the refundable credit is limited to the amount of tax paid by the fifteenth day of the third month after the end of the tax year. As a result, any payment submitted after that date is not eligible for a credit in the same tax year that the flow-through entity's members report the associated income. Those payments, however, may be eligible for a credit in the members' following tax year.⁴⁹

Example:

FTE is a calendar year taxpayer and timely paid \$1,000 in quarterly estimated tax payments for Year 1. FTE also requested and received an extension of time to file the Year 1 annual return. When filing the Year 1 return on September 30, Year 2, FTE determined that additional tax was owed and paid an additional \$500 in tax, plus \$100 in combined penalty and interest. For members of FTE, the Year 1 credit is based on each member's share of the \$1,000 in taxes paid as of March 15, Year 2. Even though the additional \$500 tax payment was paid toward FTE's Year 1 liability and by the extended due date of that return, that payment is not eligible for a Year 1 credit. Instead, that payment may be claimed as a credit by members in Year 2. The \$100 payment attributable to penalty and interest is not eligible to be claimed for the credit in any tax year.

The FTE should account for these limitations when reporting each member's share of flow-through entity taxes paid. And, to the extent applicable, each of the various components of the credit must be reported separately to each member rather than as a lump sum amount. Most individual members of the flow-through entity may combine those amounts as reported to them and claim a credit on their returns for the applicable tax year; however, detailed records may be required upon audit.

Special instruction for 2021. Because enactment of the legislation was not expected until the end of the 2021 year, such that significant delays were anticipated in the processing of returns for this initial tax year, the statute provides that, for the tax year 2021 only, any refund reflected on an annual return under Part 1 or Part 2 of the Income Tax Act that is attributed to the credit for the member's share of flow-through entity tax will not accrue any interest.⁵⁰

b. Credit Adjustment for Trusts and Estates

The credit is generally available for trusts and estates that are direct or indirect members of an electing flow-through entity. While the credit for these taxpayers is subject to the same limitations above, additional adjustments are required for resident and nonresident fiduciaries (i.e., estates and trusts). As a general matter, fiduciaries are typically subject to tax only on the Michigan portion of taxable income retained by the fiduciary. To ensure the refundable credit matches the income ultimately subject to tax at the fiduciary level, any credit claimed by a fiduciary must be prorated by the ratio of flow-through entity income retained to total flow-through entity income included in distributable net income of the fiduciary. And, because nonresident fiduciaries are not

⁴⁹ See MCL 206.839(1)(d)(ii).

⁵⁰ MCL 206.254(5) (excluding all interest, including "bonus" interest); MCL 206.675(3).

required to add back flow-through entity taxes in the computation of their tax base, those members are further limited to a 95.75% credit *before* that proration. Thus, the amount of the credit claimed on an annual return for a fiduciary is subject to the following two-step calculation:

1. *For nonresident fiduciaries only*, first multiply the credit reported by the flow-through entity by 95.75%.
2. *For resident and nonresident fiduciaries*, multiply the applicable credit amount (for residents, the amount reported by the flow-through entity; for nonresidents, the result of step 1) by the ratio of flow-through entity income retained by the fiduciary to total flow-through entity income included in distributable net income of the fiduciary. The result from this step is the amount of refundable credit that the fiduciary is eligible to claim on its annual return.

Example:

Nonresident Trust (NT) receives a distributive share of income of \$24,150 from electing flow-through entity (FTE), of which \$19,150 is apportioned to, and taxable in, Michigan. Based on the tax levied on and paid by it, FTE reports that NT has an allocated credit for flow-through entity taxes equal to \$850. NT retains 75% of its income, including income earned as a distributive share, and distributes the remaining 25% to beneficiaries.

Nonresident Trust Calculation		
MI Flow-Through Income Retained ($\$19,150 * 75\%$)		14,363
Michigan Tax @ 4.25% (rounded)		610
Total Credit Reported by from FTE	850	
Step 1: Adjust for 95.75% of total	813	
Step 2: Adjust for 75% income retained	610	
Adjusted credit from FTE		(610)
Total Amount Due		0

A fiduciary may also have reporting requirements under PA 135. If income is passed through to beneficiaries and the fiduciary receives a refundable credit based on the flow-through entity tax, the fiduciary must report to beneficiaries, along with income and any other required information and by the due date of the fiduciary's annual return, each beneficiary's allocable share of the credit distributed. The credit distributed is determined by multiplying the amount of the credit reported to the fiduciary by the ratio of flow-through entity income distributed to the beneficiaries to total flow-through entity income included in the distributable net income of the fiduciary.

c. Credit for Members Subject to Corporate Income Tax

The credit is technically available for members subject to tax under Part 2 of the Income Tax Act (corporations, insurance companies, and financial institutions)⁵¹ even though the flow-through entity tax is not levied on shares of income attributed to those members.⁵² The credit remains necessary, however, because in certain tiered structures, an electing entity may not know the identity of its indirect members, yet is required to pay tax attributed to any direct member that is another flow-through entity. In these cases, it is possible that the flow-through entity tax is paid on income attributable to an indirect member that is a corporation, insurance company, or financial institution. To ensure that tax is not paid at both the entity and member levels, the corporation, insurance company, or financial institution may therefore claim the refundable credit on their respective Corporate Income Tax return. The credit is available only to accommodate these unique circumstances and flow-through entities may not elect to pay tax for the purpose of generating a credit for direct members subject to tax under Part 2 of the Income Tax Act. Thus, an electing flow-through entity must exclude from its business income tax base any income attributable to its direct members that are subject to the tax under Part 2 of the Income Tax Act.⁵³

B. What adjustments are necessary on the member return for taxes paid by the flow-through entity?

PA 135 amended Part 1⁵⁴ and Part 2⁵⁵ of the Income Tax Act to require certain members to add back their direct or indirect allocable share of taxes paid by a flow-through entity in the computation of Michigan taxable income. Except for nonresident fiduciaries, financial institutions, and insurance companies, which do not have a required addition due to the computation of their respective tax bases,⁵⁶ this addition is designed to reverse the state tax impact of the federal tax deduction reported by the flow-through entity for the payment of the flow-through entity tax. For this reason, the flow-through entity must report to each member their allocable share of taxes paid under the flow-through entity tax that were *deducted* on the flow-through entity's return for that tax year. Based on this addition, the member is eligible to claim the full refundable credit for the share of tax paid by the flow-through entity.

Example:

FTE elects to pay the flow-through entity tax in Year 3. It reports to Individual A a distributive share income of \$96 on the Federal Schedule K-1, which includes a deduction of \$4 in Michigan flow-through entity taxes paid. FTE separately reports to Individual A the \$4 of flow-through entity

⁵¹ MCL 206.675.

⁵² MCL206.815(5).

⁵³ *Id.*

⁵⁴ MCL 206.30(1)(b).

⁵⁵ MCL 206.623(2)(b).

⁵⁶ For example, the tax base of a financial institution subject to the franchise tax under Part 2 of the Income Tax Act is based on total equity capital. MCL 206.255. A financial institution's tax base will not be impacted by a flow-through entity's deduction of Michigan flow-through entity taxes paid at the federal level such that an addition is not required.

taxes it deducted federally and a \$4 credit for the taxes levied for Year 3 and paid by the due date of that return. Individual A reports the \$96 distributive share in adjusted gross income. In computing Individual A's Michigan individual income tax return for that same year, Individual A must add back the \$4 of Michigan flow-through entity taxes deducted by the flow-through entity, and will be eligible to claim the \$4 credit from FTE. With these adjustments, the member owes no additional tax on the Michigan return.

Individual A's Michigan Return	
Adjusted Gross Income	96
Addition for taxes deducted by FTE	4
Michigan Taxable Income ⁵⁷	100
Michigan tax due @ 4.25% (rounded)	4
Credit from FTE	(\$4)
Total amount due from Member	<u>\$0</u>

C. What adjustments are necessary on the member return for flow-through entity taxes that are refunded to the flow-through entity?

Electing flow-through entities that overpay the flow-through entity tax will receive a refund of that overpayment with interest as provided under the applicable provisions of the Revenue Act.⁵⁸ When received, that refund may be included in the federal taxable income of the flow-through entity. Consequently, the refund may also be included in the distributive share of its members, which will later be used to determine Michigan taxable income for each member. Thus, to prevent the state taxation of certain refunds issued under the flow-through entity tax, PA 135 allows any direct or indirect allocated share of a refund of the Michigan flow-through entity tax to be deducted from the tax base of those members subject to tax under Part 1 of the Income Tax Act.⁵⁹ However, because tax refunds are not generally deductible under Part 2 of the Income Tax Act, there is consequently no similar deduction for corporations, insurance companies, or financial institutions that receive a direct or indirect allocated share of a Michigan flow-through entity tax refund. Flow-through entities are required to report to members any direct or indirect share of flow-through entity tax refunds included in income so that the members' deductions, if applicable, can be reported accurately.

Example:

FTE made estimated payments of \$100 entirely in Year 1. FTE's tax liability as established on the Year 1 return filed in Year 2 was only \$80. FTE accordingly receives a \$20 refund when the return is processed in Year 2. That \$20 refund was included in FTE's Year 2 income and included in the Year 2 distributive share and, consequently, the adjusted gross income of individual members, A (75% owner) and B (25% owner).

⁵⁷ Personal exemptions have been ignored for purposes of the examples in this Notice.

⁵⁸ MCL 205.30.

⁵⁹ MCL 206.30(1)(q)(i); MCL 206.36(1)(b).

Members A and B subtract their allocable shares of the refund, which are \$15 and \$5, respectively.

Special instruction for 2021. Because 2021 is the initial implementation year of the flow-through entity tax, there will not be any refunds of flow-through entity taxes received during 2021 or deductible on 2021 tax returns.

D. How will the flow-through entity tax impact the estimated tax payments of members of an electing flow-through entity?

Individual and fiduciary members are generally required to make estimated payments if their expected annual tax is greater than \$500.⁶⁰ In determining the estimated tax obligation, the annual tax liability is determined after applying all credits and payments applicable to the taxpayer's liability. The refundable credit based on the flow-through entity tax that was paid by an electing flow-through entity will reduce an eligible member's expected annual tax liability. Accordingly, a direct or indirect member of an electing flow-through entity is not required to make estimated tax payments for flow-through income that will be subject to the flow-through entity tax and for which the member will receive a refundable credit.

Special instruction for 2021. The refundable credit received for taxes paid by an electing flow-through entity will reduce a member's 2021 annual tax liability. Members of an electing flow-through entity may adjust their upcoming estimated payment — due January 18, 2022, for calendar year filers — as appropriate to reflect the refundable credit that member will receive for tax paid by an electing flow-through entity for 2021. Because the credit effectively reduces the member's annual tax liability, members may adjust their upcoming estimated payment even if the flow-through entity has not yet elected or paid the flow-through entity tax as of the due date of that estimated payment.⁶¹ Members of an electing flow-through entity that have made estimated tax payments throughout 2021 may now have significant overpayments for tax year 2021. Those taxpayers should report those payments on the annual return filed for tax year 2021 and will receive a refund of those overpayments upon the processing of that return.

E. How will composite returns be impacted by the flow-through entity tax?

Flow-through entities are permitted under the Income Tax Act to file composite returns on behalf of participating nonresident individual members.⁶² The Individual Income Tax Composite Return (Form 807) reports income and pays any tax due from, participating

⁶⁰ MCL 206.301(1).

⁶¹ See Form MI-2210, Line 5. For example, assume that Member 1 has been remitting estimated tax payments during the year and will receive a credit from an electing flow-through entity for tax year 2021. Member 1 determines that an estimated payment would not be due on January 18, 2022 based on that credit. The entity plans to elect into and pay the Michigan flow-through entity tax as permitted sometime after January 18, 2022. Member 1 can still adjust the estimated payment as long as the flow-through entity will later elect into and pay the flow-through entity tax for tax year 2021. However, if the flow-through entity does not ultimately make the election such that Member 1 does not actually receive any credit for that year, then Member 1 could be subject to penalty and interest for underpayment of the estimated tax payment due on January 18, 2022.

⁶² MCL 206.315(2).

nonresident individual and fiduciary members based on that flow-through entity's business activities within Michigan and, as such, may satisfy the return filing and payment obligations of those participating nonresidents.⁶³ In contrast, the filing of a flow-through entity tax return reports income of, and tax levied on, the entity and will not satisfy the respective filing obligations of these nonresident members nor claims the refundable tax credit generated by the electing flow-through entity. Accordingly, the filing of an individual income tax composite return as permitted under Part 1 of the Income Tax Act is a separate and distinct obligation from the filing of a flow-through entity tax return under Part 4 of the Income Tax Act. Electing flow-through entities may therefore need to file both returns, if nonresident members elect to participate in a composite return over separate filings

Special instruction for 2021. Electing flow-through entities should file a flow-through entity return and, if applicable, a composite return for tax year 2021. Any estimated payments made on behalf of the nonresident members participating on the composite return will not be applied to the flow-through entity tax return. Any payments due under the flow-through entity tax must be made regardless of any previous composite return estimated tax payments.

III. Questions

For further questions, please contact the Business Taxes Division at 517-636-6925 and follow the prompts for Corporate Income Tax/Flow-Through Entity.

⁶³ See MCL 206.315. The filing obligation of participants is fulfilled to the extent they have no Michigan income from other sources.