Michigan Department of
# TREASURY UPDATE

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## FLOW-THROUGH ENTITY TAX REPORTING UPDATES

Over the course of these last 2 years, it's been a challenge to stay up to speed with the elective tax on flow-through entities, which was enacted retroactively by 2021 PA 135 (see *Michigan Enacts an Elective Flow-Through Entity Tax* in the February 2022 issue). One of the steepest learning curves with the Flow-Through Entity (FTE) tax has involved tiered entities and indirect credits. The terms "tiered" or "indirect" credits describe credits generated by FTE taxpayers (credit-generating entities) that have one or more direct owners that are other flow-through entities. Those other flow-through entities cannot claim the credits and must pass them through to their owners via reporting required under the statute. Each respective share of a credit is ultimately claimed by taxpayers subject to Michigan individual income tax—i.e., a credit-generating entity's indirect owners. To aide taxpayers with reporting and streamline return processing, Treasury has recently developed additional guidance and changed a form requirement.

**Reporting to Members Templates Available**

As discussed in previous guidance, certain specific information about the credit, tax base adjustments, and credit-generating entity must be reported to members by flow-through entities, regardless of whether a flow-through entity elects into the tax. See MCL 206.839. Because the statute does not mandate any particular form or manner, flow-through entities can report the required information in Schedule K-1 notes or any other format it chooses.

It's become clear that taxpayers, their preparers, and Treasury staff may benefit from uniform templates that demonstrate the level of detail required. Therefore, Treasury developed two templates, "Michigan Flow-through Entity Tax Information for Direct Members" (direct template) and "Indirect Share of Michigan Flow-through Entity Tax Information for Direct Members" (indirect template), and published them earlier this year at www.michigan.gov/taxes/business-taxes/flowthrough-entity-tax/report-and-pay-fte. Taxpayers are encouraged, but not required, to use the templates, which can be attached as a PDF to an e-filed MI-1040 or MI-1041 return.

The Report and Pay web page includes some basic instruction, links to the templates, and a comprehensive example of indirect credit reporting. Please note that the direct template is also applicable to simpler structures that are not tiered. Also, when using the indirect template, the credit generating entity should always be reported as the Indirect Entity, even when there are multiple tiers between the credit generating entity and the individual, trust, or estate that will ultimately claim the credit.

**Reporting Indirect Members on Form 5774 Now Permitted**

The FTE annual return filing includes *Schedule for Reporting Member Information for a Flow-Through Entity* (Form 5774). Part 2 of that form reports individuals, fiduciaries, and other flow-through entities and their respective shares of the tax (credit). Previously, instructions for that section stated that

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only direct members could be listed. Recently, updates have been made to remove that restriction. Beginning with 2022 FTE returns that have not yet been filed and all returns going forward, FTE taxpayers are permitted to report indirect members and their respective shares of income and credits in lieu of listing the direct member that is another flow-through entity. This may reduce processing times for indirect members and requests for additional information.

## LEGISLATURE ENACTS 75% "PREPARED FOOD" STANDARD

The Use Tax Act (UTA) and the General Sales Tax Act (GSTA) exempt "food or food ingredients, except prepared food." Before PAs 141 and 142, the UTA and the GSTA defined "prepared food" to include "food sold with eating utensils provided by the seller," but that term was not defined by statute. To define that term, Treasury promulgated a rule in 2007, but the Court of Appeals struck down that part of the rule in *Emagine Entertainment v Department of Treasury*, 334 Mich App 658 (2020). Now, in PAs 141 and 142, the Legislature has enacted statutes defining that term and others in a way that essentially resurrects the struck-down part of the rule.

The new statutory definition of "food sold with eating utensils provided by the seller," codified in MCL 205.54g and MCL 205.94d, creates a bifurcated scheme in which the tax treatment of such food depends on a so-called "prepared food sales percentage," a ratio of sales of "prepared food" to sales of all food. Calculation of that percentage is described in a forthcoming RAB entitled "Food for Human Consumption." But in broad terms, a high "prepared food sales percentage" means that sales of prepared food predominate—consider, for example, a typical restaurant. A low ratio, on the other hand, could characterize a typical grocery store.

Where the "prepared food sales percentage" is 75% or less, food is "prepared food" if the "seller's business practice is to give or hand eating utensils to purchasers" or the seller makes available "eating utensils necessary for the purchaser to receive the food, such as bowls and cups." As an example, consider a business comprising a grocery store with an icecream counter and a "prepared food sales percentage" of 10%. Suppose the store's practice is to hand napkins to purchasers at the ice cream counter—because a "napkin" is an "eating utensil" under the UTA and GSTA, the food bought at the ice-cream counter is taxable as "prepared food." Now suppose that the counter includes a customer-operated dispenser of soft-serve ice cream, and the store puts bowls next to the dispenser. Because a bowl is "necessary for the purchaser to receive" the ice cream and the store made the bowl available to the purchaser, the ice cream dispensed into the bowl is taxable as prepared food.

Where the "prepared food sales percentage" tops 75%, the new laws create two categories of food. The first category includes bottled water, candy, and soft drinks. Those items become "prepared food" if "the seller gives or hands the eating utensils to purchasers or makes plates, bowls, glasses, or cups that are necessary for the purchaser to receive the food available to purchasers." All other food items become "prepared food" if the "seller makes eating utensils available to purchasers." Unlike the example above about a bowl for soft-serve ice cream, the "make available" rule here does not require that the utensils be "necessary for the purchaser to receive the food." As an example, consider a business comprising a restaurant with a small shop selling specialty groceries and a "prepared food sales percentage" of 85%. If the shop makes napkins (a type of eating utensil) available at checkout, then the food it sells is taxable as "prepared food." It doesn't matter whether a napkin is necessary for the purchaser to receive the food or whether the napkin is not given or handed to the purchaser.

PAs 141 and 142 will take effect February 13, 2024.

## RECENTLY ISSUED GUIDANCE FROM TREASURY

**Revenue Administrative Bulletins**

**RAB 2023-16 Sales and Use Tax – Taxability of Delivery and Installation Charges,** Approved: September 11, 2023

**RAB 2023-22 Individual Income Tax- Treatment of Retirement Income Under Public Act 4 of 2023,** Approved: November 22, 2023

**Notices**

- **Notice Regarding Revisions to Michigan's Sales and Use Tax Rules,** Issued: September 13, 2023
- **Notice of Tax Rate Calculation on Gross Premiums Attributable to Qualified Health Plans for Tax Year 2023,** Issued September 27, 2023

**Statement of Acquiescence/Non-Acquiescence Regarding Certain Court Decisions**

In each issue of the quarterly Treasury Update, Treasury will publish a list of final (unappealed), non-binding, adverse decisions issued by the Court of Appeals, the Court of Claims and the Michigan Tax Tribunal, and state its acquiescence or nonacquiescence with respect to each. "Acquiescence" means that Treasury accepts the holding of the court in that case and will follow it in similar cases with the same controlling facts. However, "acquiescence" does not necessarily indicate Treasury's approval of the reasoning used by the court in that decision. "Non-acquiescence" means that Treasury disagrees with the holding of the court and will not follow the decision in similar matters involving other taxpayers.

ACQUIESCENCE: None this quarter

NON-ACQUIESCENCE: None this quarter

# CHECK THE BOX! IT'S NOW EASIER FOR TAXPAYERS TO HELP SAVE LIVES

Did you know that every 10 minutes another person is added to the organ wait list according to organdonor.gov? It is now easier to sign up as an organ donor in Michigan. Under public acts, 2023 PA 100-102, beginning with tax year 2023, individuals filing a Michigan income tax return will now have an opportunity to help those on a wait list by including their name on the organ donor registry.

State tax forms instructions will include information about organ donation and the "check the box" option for taxpayers. "This check-off will be added to the form containing other charitable contribution questions, such as donations to the Red Cross or United Way, which already exist on our tax forms," commented Chief Deputy Treasurer Jeff Guilfoyle. "The instructions, which for this form are included on the back of the page they are printed on, will contain information on what taxpayers agree to by checking that box." Form 4642 Michigan Voluntary Contributions and Anatomical Gift Donor Registry Schedule is the form that will have a check the box schedule to be filled in if an individual taxpayer wishes to be included on the organ donor registry.

Under this voluntary program, taxpayers will be able to affirm their desire to include their name, address and an identification number on a schedule that will be filed with their tax return. The identification number can be the last four digits of their Social Security number, a driver's license number or other State personal identification number. For taxpayers that file a joint return, each person will have the opportunity to affirm their desire to have their name placed on the registry.

Treasury will work in conjunction with the Secretary of State that will confidentially receive the information from Treasury and maintain the donor registry that may be shared with organ donation organizations consistent with the Public Health Code, 1978 PA 368, MCL 333.10120.

Tax practitioners may wish to inform their clients of this new voluntary option and include a question on their tax intake forms so that the organ donor registry schedule can properly be completed according to the taxpayer's wishes. Remember, the taxpayer must affirm their desire to be placed on the registry and have the Form 4642 "check the box" schedule completed on their behalf to be filed with their MI 1040.

One person can save and improve the lives of 75 people through organ, tissue, and eye donation. For more information on the life-saving gift of organ donation, please visit Organ Donation (michigan.gov).

# COURT OF CLAIMS UPHOLDS SALES TAX AUDIT OF DENTAL LABORATORY

In a recent opinion in *LaDouce Dental Laboratory Co., Inc. v Department of Treasury*, the Michigan Court of Claims upheld a sales tax audit of a dental laboratory that made retail sales of custom manufactured dental products to dentists.

The taxpayer is a dental laboratory that custom manufactures and sells certain dental products to dentists, including bite splits, bleaching trays, and sport guards. A sales tax audit for the 2018 tax year concluded sales of the above products were not exempt "dental prosthesis" and were therefore taxable sales at retail. Because sufficient records of those retail sales were not made available during the audit, Treasury relied upon the best available information to compute the resulting sales tax deficiency on those transactions. The taxpayer filed suit in the Michigan Court of Claims to challenge that deficiency, ultimately asserting that tax was not owed on two alternative grounds: (1) all sales of the above products should have been considered exempt sales of "dental prosthesis" under MCL 205.54a(1)(r); and (2) all of its sales to dentists should have been considered exempt "sales for resale" under MCL 205.51(1)(b).

The court rejected the taxpayer's reliance on the "dental prosthesis" exemption on procedural grounds. The complaint filed with the Court of Claims did not assert the "dental prosthesis" exemption and instead asserted only that the taxpayer's sales were exempt "sales for resale." The taxpayer did not formally assert entitlement to the "dental prosthesis" exemption until the filing of the taxpayer's motion for summary disposition, which occurred after the close of discovery. Because the complaint did not provide sufficient notice of the taxpayer's reliance on that exemption, and because the taxpayer never sought to amend its complaint to provide that notice, the court found the taxpayer had essentially waived its right to argue the merits in subsequent proceedings. Thus, the court did not consider the merits of the taxpayer's claim that the "dental prosthesis" exemption applied to its retail sales.

In resolving the remaining claim that the taxpayer's sales were otherwise exempt "sales for resale," the court found the taxpayer failed to provide sufficient proof to substantiate that claim. Citing to MCL 205.68(1) – which requires taxpayers to keep accurate records of sales and any exemptions therefrom – the court held that the taxpayer was statutorily required to "come forward with some records to substantiate its claim of a tax exemption." In that regard, although the taxpayer did produce completed exemption certificates for some customers during the course of litigation, those certificates could not be reconciled to detailed sales reports, could not be tied to product sales made to customers, and did not even purport to claim the resale exemption upon which the taxpayer was now relying. For all of these reasons, the court concluded the taxpayer failed to meet its burden of proving that its sales were exempt "sales for resale" under MCL 205.51(1)(b).

Because the taxpayer had not provided sufficient evidence to support the application of the resale exemption to its sales, the court held Treasury's auditor was justified not only in treating the retail sales of the taxpayer's manufactured dental products as taxable, but also in determining the resulting liability based on the best information available. As such, the court upheld Treasury's audit assessment issued for the 2018 tax year. [As of the time of publication of this article, this decision has not yet been appealed.]

## FIREARM SAFETY DEVICES WILL BE TAX-FREE FOR PART OF 2024

From May 13, 2024, through December 31, 2024, firearm safety devices are exempt from sales and use taxes. Specifically, PA 14 and 15 of 2023 exempts these items from the tax during this period and requires gun retailers to notify purchasers of the exemption by providing them a written notice and posting the information conspicuously in gun stores. These exemptions include trigger locks and other devices aimed at preventing unauthorized discharge of the weapon without "deactivating" it, as well as gun safes, gun cases, lock boxes and the like. Glass-faced display cases are not covered. Exemption is not contingent upon the purchase of a weapon.

## ABOUT TREASURY UPDATE

Treasury Update is a periodic publication of the Tax Policy Division of the Michigan Department of Treasury.

It is distributed for general information purposes only and discusses topics of broad applicability. It is not intended to constitute legal, tax or other advice. For information or advice regarding your specific tax situation, contact your tax professional.

For questions, ideas for future newsletter or Revenue Administrative Bulletin topics, or suggestions for improving Treasury Update, contact:

**Lance Wilkinson**
Director, Tax Policy Bureau
517-335-7477

**Dave Matelski**
Administrator, Tax Policy Division
517-335-7478

**Email address:**
Treas_Tax_Policy@michigan.gov

## ATTENTION TAXPAYERS THAT CLAIM THE DATA CENTER EXEMPTION

Treasury is requesting that all data center operators who claimed a sales or use tax exemption for the sale or purchase of data center equipment submit form 5726 by January 31st. Sales and use tax exemptions play a large role in overall revenue allocation and exemptions taken by data centers are no exception as they directly affect the School Aid Fund, General Fund, and other revenue distributions. The Department must determine the amount of revenue lost to the School Aid Fund from claiming these exemptions under MCL 205.54ee and/or MCL 205.94cc and has implemented a process to mandate certain reporting obligations on persons claiming these exemptions.

Public Acts 29 and 30 ("Acts") of 2020 became effective February 13, 2020. These Acts established certain reporting obligations on persons claiming sales or use tax exemptions regarding the sale or purchase of data center equipment. More specifically, the Acts require such persons to annually report the sales or purchase price of equipment sold to, or purchased by, them each calendar year in which the exemptions were claimed. The Acts also established that this reporting must be submitted on a form and at the time and in the manner prescribed by Treasury. For the purpose of reporting the information required by the Acts, Treasury has issued form 5726 (Report for Qualified Data Center Exemptions). This form must be filed no later than January 31st of the year immediately following the close of the calendar year. Keep in mind that the filing of this form is to fulfill the reporting obligations under the Acts and is not a means for claiming an exemption. If no Equipment was sold or purchased or an exemption was not claimed in a particular calendar year, the filing of form 5726 is not required. The form itself, and instructions on completing and submitting the form can be found under the Business Taxes (Sales and Use Tax) Forms and Instructions section at www.michigan.gov/taxes.

For more information regarding the data center exemptions, please refer to Treasury's Notice Regarding Data Center Exemption which was updated on March 14, 2016. This will provide you with everything you need to know about what sales or purchases are exempt. For questions concerning the filing of Form 5726, please direct your inquiries to Tax Technical Services at 517-636-4357.

## U.S. SUPREME COURT WILL NOT HEAR MICHIGAN APPORTIONMENT CASE

On July 31, 2023, in *Vectren Infrastructure Services v Department of Treasury,* a divided Michigan Supreme Court issued a 4-3 decision in favor of Treasury, ruling that the business income of an out-of-state taxpayer is apportionable even if the sale of a business occurred in another state so long as the tax is assessed in a proportionate manner. Following this decision, on October 25, the taxpayer filed a Petition for a Writ of Certiorari with the U.S. Supreme Court arguing that Michigan's statutory single sales factor apportionment formula led to a grossly distorted result and was unconstitutional.

Several organizations filed Amici Curiae briefs on behalf of the taxpayer. On November 20, 2023, the Court denied the taxpayer's petition. This concludes the case and preserves the opinion of the Michigan Supreme Court that is precedential. The opinion confirms that the relevant question remains whether the sales factor fairly represents the business activity conducted in Michigan during the tax period. Taxpayers must prove by clear and cogent evidence that the income in question is not related to their business activities in Michigan, and they may not use an apportionment formula that differs from the single sales factor formula without approval from Treasury. Rather, taxpayers must petition Treasury for an alternative apportionment method. See Revenue Administrative Bulletin 2018-28 for information on how to petition Treasury for alternative apportionment relief.

# COURT OF APPEALS CLARIFIES "RESEARCH OR EXPERIMENTAL ACTIVITIES" UNDER THE INDUSTRIAL PROCESSING EXEMPTION

In a recently published opinion, the Court of Appeals in *Strata Oncology, Inc v Department of Treasury* upheld Treasury's interpretation and application of the "research or experimental activities" prong of the industrial processing exemption located in Section 4o of the Use Tax Act, MCL 205.94o.

The taxpayer operated as a "precision oncology company" that used specialized lab equipment to perform tests on tissue samples in order to develop and maintain patient DNA and RNA profiles. Taxpayer partnered with pharmaceutical companies and used those genetic profiles to provide a highly targeted form of patient selection for cancer drugs undergoing Food and Drug Administration (FDA) trials. It was undisputed that the partnered pharmaceutical companies are "industrial processors" performing an exempt industrial processing activity related to drug manufacturing. Based on its relationship to those entities, the taxpayer asserted that it was eligible for the industrial processing exemption on the basis it was performing an exempt "research or experimental activity" on behalf of those industrial processors. Thus, the issue before the court in this case was whether the taxpayer was performing an exempt "research or experimental activity" for or on behalf of its partnered pharmaceutical companies.

The industrial processing exemption is codified at Section 4o of the Use Tax Act, MCL 205.94o. The exemption applies, in pertinent part, to "[a] person, whether or not the person is an industrial processor, if the tangible personal property is used by that person to perform an industrial processing activity for or on behalf of an industrial processor." MCL 205.94o(1)(c). An "industrial processing activity" is defined to include, among other things, "research or experimental activities." MCL 205.94o(3)(b). There are two ways an activity may constitute a "research or experimental activity" — an activity may be (1) "incident to the development, discovery, or modification of a product or a product related process" or (2) an activity may be "necessary for a product to satisfy a government standard or to receive government approval." MCL 205.94o(8)(f).

Applying the above framework, the Court affirmed the Michigan Tax Tribunal in concluding that the taxpayer was not engaged in an exempt "research or experimental activity."

First, the Court held the taxpayer's activities were not "incident to the development, discovery, or modification of a product or product related process." Although there was some dispute as to whether the "product" refers to the taxpayer's patient matching services or to the trial drug, the Court held the taxpayer's claim would fail in either context. If treating the "product" as the patient matching services, then the Court found the taxpayer would no longer be eligible for the industrial processing exemption to the extent any "development, discovery, or modification" of that product was for the taxpayer's own benefit rather than for the benefit of the pharmaceutical companies. Conversely, if treating the "product" as the trial drug, then the Court found that the taxpayer's activities did not contribute to the "development, discovery, or modification" of that drug inasmuch as the patient matching services were provided after the drug had been manufactured and did not have any impact on the formulation of the drug itself. In either case, the Court concluded that the activity of provisioning of trial patients to pharmaceutical companies was not "incident to the development, discovery, or modification of a product or product related process."

Next, the Court concluded that the taxpayer's operations were not "necessary" for a trial drug to obtain FDA approval. In reaching that result, the Court rejected the taxpayer's argument that "necessary" should be defined similar to an "ordinary and necessary" business expense under IRC 162. Declining to import a technical meaning developed in a different tax context, the Court held that "necessary" should instead be understood consistent with its common and ordinary meaning, which, through reference to a dictionary definition, means "absolutely needed." Applying that definition, the taxpayer's operations were not absolutely needed for trial drugs to receive governmental approval — indeed, pharmaceutical companies could use other patient providers within a drug trial, pharmaceutical companies could select patients using a traditional non-targeted approach, and pharmaceutical companies could obtain FDA approval without the taxpayer's work altogether. The Court therefore held that the taxpayer's business operations were not "necessary" for the trial drugs to obtain government approval.

For all of the above reasons, the Court concluded that the taxpayer was not engaged in a "research or experimental activity." Because the taxpayer was accordingly not eligible for the industrial processing exemption, the Court of Appeals upheld Treasury's audit determination that use tax was owed on the lab equipment and lab supplies used in the taxpayer's operations.

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