

# Tax Newsletter

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TAXATION SECTION

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## MICHIGAN'S SINGLE BUSINESS TAX

BY

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COMMISSIONER OF REVENUE

STATE OF MICHIGAN

The first time Michigan altered its business tax structure was in 1953 when it enacted a "Business Activities Tax." This was very similar to a value added tax but was essentially a gross receipts tax which permitted more exemptions and deductions than a pure value added tax. This was replaced by a corporate income tax effective January 1, 1968.

In 1972 a constitutional amendment was proposed as part of state financing of public schools which carried a plan for a value added tax. The voters, not understanding the proposal, reacted by soundly defeating it at the polls.

Many voters thought at that time the tax structure was sufficient to carry the state through all sorts of adversity. Again in 1975 the governor proposed a value added tax for the state. After meeting with numerous labor groups, business groups and legislative leaders a bill was drafted and placed before the House of Representatives.

Proponents of this new concept of taxation claimed that it would stabilize state tax revenues, promote economic expansion by providing essentially for growth and efficiency and make for modern and improved industrial economy. This Single Business Tax would apply to every individual, corporation, partnership, financial institution, estate and trust, with business activity allocated or apportioned to Michigan under provisions of UDITPA.

The eight existing taxes to be replaced are corporate income tax which produced \$275 million; corporate franchise tax, \$156 million; the business portion of the intangibles tax, \$35 million; the financial institutions tax, \$16 million; personal property tax on inventory levied by local governments, \$310 million; savings and loan association privilege taxes, \$2 million; domestic insurance carrier privilege tax, \$1 million and the business portion of the individual income tax, \$5 million. All taxes to be replaced total \$800 million.

After the introduction of the bill in the House of Representatives a similar bill was introduced in the Senate at which time Touche Ross and Company was employed to analyze it and to determine how the tax burden would shift in Michigan.

With the cooperation of the Department of Treasury a sampling was made of the income tax return of 807 corporations<sup>1</sup> which was broken into 29 different categories. The results of the study showed that there would be a decrease in the tax burden for 21 categories and an increase in the tax burden for 8. The following grouping shows the increase or decrease in their tax burden.

	SENATE VERSION	HOUSE VERSION
14 Agriculture, Forestry & Fisheries	95%	86% <sup>2</sup>
20 Mining	(24%)	(06%)
21 Construction	63%	88%
382 Manufacturing	(21%)	(11%)
94 Transportation, Utilities, etc.	(33%)	(37%)
27 Wholesale Trade	(36%)	(20%)
88 Retail Trade	(01%)	28%
56 Insurance, Real Estate & Finance	(49%)	(42%)
105 Services	45%	57%
<u>807</u>		

The new bill brought forth many problems, mainly protests from financial, quasi financial firms and high labor intensive firms. The financial and insurance industries also presented specific problems because of their special federal tax treatment and also a variety of financial and quasi financial firms which have subsidiaries, some of which are nonfinancial. As for insurance carriers there are problems with loss reserves and interest and dividends paid or credited to stockholders. Other types of businesses created problems because of their unique accounting practices - firms such as co-ops, farming, fiduciaries and regulated industries.

#### FEATURES OF THE ACT

The Single Business Tax act is a type of value added tax and its key feature is that the tax liability of every business is proportional to its economic size. The tax applies equally to every business, and the amount of tax paid is independent of the legal form of the business, the nature of the business and the particular production or financing means chosen by the business.

In contrast, the taxes being repealed are clearly not neutral in their impact and were necessary elements in internal business decision making. For example, franchise tax applied only to corporations but was a significant tax only for heavy manufacturing and utility industries. The inventory tax was significant only in retailing, wholesaling and integrated manufacturing. The corporation profits tax applied only to

<sup>1</sup>Confidentiality provisions of Michigan's income tax laws prevented disclosure of taxpayer's names.

<sup>2</sup>Decrease ( )  
Increase

large corporations and the amount of the tax due depended mainly upon the firms accounting practices.

The Single Business Tax eliminates these distinctions. Its passage is the first step taken to free business from making economic decisions in order to minimize its tax liability. The tax is a 2.35% levy on the sum of profits (or losses), payroll (including fringe benefits), net interest paid and depreciation, less capital expenditures. This sum represents the economic size of each business or is the same type of calculation used to add up the gross national product for the whole country. The sum is also equal to the amount of income paid by each business to make its products or services. The tax base is the sum of payments to owners (profits, interest and depreciation) and employees (wage and fringe benefits). Thus, the tax base for each business is proportional to its economic size.

The legislature did recognize a few deviations from the tax base to minimize the change in tax liability that could otherwise occur in the shift to another tax system. Special provisions are included for retail food dealers, the construction industry, professional service firms, and firms that operate with very little capital equipment.

The Act defines the additions to the tax base as being:

- (A) Any carryback or carryforward of a net operating loss;
- (B) Any capital loss incurred after the effective date of the act;
- (C) Any deductions for depreciation on federal returns pursuant to Section 23,<sup>3</sup> for 1976 72% on other depreciation, for 1977 50%, and years thereafter 40%;
- (D) All dividends paid;
- (E) Any deductions taken due to one's status as a disc;
- (F) All interest paid; (special provisions for insurance companies);
- (G) All royalties paid.

All compensation, as defined in the statute, must be added to the tax base as also must be added capital gains to the extent excluded in arriving at federal taxable income.

The Act also provides for deductions from the tax base as follows:

- (A) All dividends received to the extent included in arriving at federal taxable income;
- (B) All interest;
- (C) All royalties;
- (D) Capital losses not deducted in arriving at federal taxable income.

<sup>3</sup>Section 23 is the adjustment to the tax base allowing the deduction for fabrication and installation of personal property and/or real property.

There are certain other technical definitions in the statute, such as unrelated business activity as being any business activity that gives rise to unrelated taxable income as defined in the Internal Revenue Code.

The Act further provides for special treatment for interest received and paid by financial organizations. The tax base of financial organizations is the sum of federal taxable income and the adjustments provided for in Section 9 of the Act. (A person whose assets are 90% intangible personal property or 90% gross income being from dividends or other charges resulting from the use of money or credit).

Section 23 of the Act allows a taxpayer a deduction from his tax base after allocation or apportionment to Michigan the net cost, including fabrication and installation, paid or accrued in the taxable year of tangible assets (not including real property) which under the Internal Revenue Code will become eligible for depreciation or amortization for federal income tax purposes. This deduction has a two-factor apportionment formula, payroll plus property and the denominator is 2.

This section of the law also allows an adjustment from the tax base for the cost of real property paid for or accrued in the taxable year and which is eligible for depreciation or amortization for federal income tax purposes. The real property must be physically located in Michigan.

Many high labor intensive organization, because of their protest against the passage of the bill, caused the legislature to amend it by providing that such labor intensive businesses may deduct from their tax base the percentage of compensation which exceeds 65% of their gross tax base.

Relief was also granted to those businesses licensed under Act 330, Public Acts of 1968 (Contract Security Guards). They may elect to reduce their adjusted tax base by the percentage that compensation exceeds 35% of the tax base. This provision expires December 31, 1977.

A person whose interest paid and whose depreciation on assets acquired before January 1, 1976, together, comprises 70% or more of the adjusted tax base which is derived from rental housing investments, may reduce his adjusted tax base by that amount which exceeds 35% of gross receipts. This does not apply to financial organizations and expires on December 31, 1977.

Section 35 provides for an exemption for the 1976 tax year of the first \$34,000 of the tax base of every person and \$36,000 for 1977 and each year thereafter. This exemption is phased out at \$2.00 for each \$1.00 that the business income exceeds the amount of the exemption.

This small business exemption is increased by \$10,000 for each partner of a partnership or shareholder of a subchapter's corporation or professional corporation in excess of one who is a full time employee of the taxpayer whose salary is included in computing the exemption, whose business income from that business is at least \$10,000 and who owns at least 10% of the business. The total increased exemption cannot exceed \$40,000. The total exemption can therefore be \$74,000 for the first year and \$76,000 for the second year and all years thereafter. A noncorporate taxpayer may elect to average his business income to include the current year and the previous four taxable years.

Relief was also granted to domestic insurer companies which may exempt that portion of the payroll which constitutes commissions paid to employees and salaries of claims adjusters. The reason for this is that insurance companies that hire employees should be given equal treatment with those that employ independent insurance agents.

Fifty percent (50%) of the compensation directly related to architectural engineering or construction contracts bid prior to September 1, 1975 are also exempt. This particular provision also expires on December 31, 1977.

The Act also provides that a business may not operate artificially as more than one corporation in order to claim more than one small exemption. An affiliated group is entitled to only one exemption also. This makes no difference whether a combined or consolidated return is filed or not. Further language in the law allows credits the same as the State Income Tax Act does for contributions to public libraries and institutions of higher education. A credit is also allowed against the single business tax of 5% of the State Utility Property Tax except for those subject to special treatment under the transportation section of the law.

Special consideration was also given to the retail food industry. A taxpayer whose business includes the sale of retail food for human consumption as defined in the Sales Tax Act and whose gross receipts from the sale of such food (as defined) equals 75% or more of the gross receipts may elect to reduce their adjusted tax base by the percentage that compensation exceeds 35% of the total tax base. The deduction cannot exceed 65% of the adjusted tax base and this provision expires December 31, 1977.

The apportionment provisions of the statute begin at Section 40. The apportionment factor is a three-factor formula of property, payroll and sales (please note the two-factor personal property apportionment in prior provisions of the law). Transportation companies are provided with a special apportionment formula based on their type of business. This apportioned tax base is finally reduced to 30%. The special provision also establishes a minimum tax for trans-

portation companies which is based on an average of five years relationship between business taxes in Michigan and gross receipts. As a further explanation, the ratio of gross receipts from passenger transportation is weighed against total gross receipts from all transportation and by the ratio of gross receipts from freight transportation to total gross receipts from all transportation.

The Commissioner has the right, however, to use other available data if, in his opinion, this will result in a more equitable allocation of receipts to Michigan. This special provision for transportation companies also expires December 31, 1977. In fact, if any of the apportionment provisions in the state do not fairly represent the extent of the taxpayer's business activity in the state, the Commissioner may require or the taxpayer may petition for either separate accounting, the exclusion of one or more of the factors, the inclusion of one or more additional factors, or any alternate method. If an alternate method is used it must be approved by the Commissioner.

The Act provides for filing of estimated quarterly payments and an annual reconciliation. The first two quarterly payments due in fiscal 1976 are to be made on the basis of half of the estimated liability. The quarterly returns are due April 30, June 30, October 31 and January 31 for taxpayers on a calendar year basis. A taxpayer who expects his liability for the tax year to be under \$500.00 or one whose adjustments under Section 23 will not exceed \$100,000.00 does not have to file estimated returns or pay an estimated tax quarterly. The Commissioner has the discretion of extending filing dates, also. However, when filing dates are extended interest at the rate of 9% per annum must be added to the amount of the unpaid tax for the period of the extension. The department may also require a tentative return and payment of estimated tax. Persons with gross receipts of less than \$34,000.00 are exempt from filing a return.

Chapter 5 of the Act, starting with Section 81, covers all administrative provisions. These are somewhat similar to the other tax statutes administered by the department and in particular the income tax statute. Interest is 3/4 of 1% per month, penalty remains at 10% for negligence or disregard of rules and regulations on an audit liability. The penalty for fraud is 100% of the tax and 1% per month interest. In case of failure or refusal to file a return or pay the tax within the time prescribed in the Act, there is a penalty of \$5.00 or 5% of the tax, whichever is greater, if the failure is not more than one month; with an additional 5% for each additional month or fraction thereof during which time the failure continues if the tax and penalty is not paid, to a maximum of 25%. Interest is also added at the rate of 1% per month.



For failure or refusal to file an information return within the time specified by the Act, penalty may be added to the return of \$5.00 per day for each day for each separate failure or refusal. However, the total penalty for each separate failure or refusal cannot exceed \$200.00. The Act also provides for the usual assessment and tax warrant procedure. A new provision regarding tax warrants authorizes third party levies. There is a four-year statute of limitations which is suspended during the period of a waiver on the taxpayer's federal income tax return or on the return required by the Act and for one year thereafter. The taxpayer and the Commissioner may consent in writing for an extension of the statute of limitations.

A new provision was inserted in the Single Business Tax Act giving a taxpayer the right to request a "conference" on an intention to levy a tax assessment. This conference is an "informal conference" and will not be subject to the provisions of Act 306 of the Public Acts of 1969, as amended, (the Administrative Procedures Act). The taxpayer has a right of appeal to the State Tax Tribunal and after the payment of the tax, he may sue for a refund but he must bring the action in the Court of Claims within 6 months after payment.

A particular innovation regarding third party warrants imposes a liability upon the holder of the taxpayer's assets for his failure or refusal to surrender property levied upon to the state. Such person is liable personally to the state in a sum equal to the value of the property he refuses to surrender but not exceeding the value of the taxes for which the levy was made. In addition, he is liable for interest at the rate of 6% per annum from the date of levy. In addition, if a person is required to surrender property and refuses to do so, without reasonable cause, he shall be liable for a penalty of 50% of the amount recoverable under the tax warrant. This penalty is not credited against the tax liability for which the levy was made. A person who does surrender such property after levy, is discharged from any obligation or liability.

The statute also has lien provisions similar to the income tax law and clearance provisions. Section 98 imposes the responsibility upon the Department of Commerce to withhold the issuance of any Certificate of Dissolution or Withdrawal of a corporation until cleared by the department. There is also a successor liability and the responsibility placed upon taxpayers to keep records for six years.

Provisions were inserted in the Act for a felony prosecution in case a person fails or refuses to make the return required by the Act, within the time required, makes a false or fraudulent return, or makes a return intending to defraud the state or to avoid payment of the tax.

The usual confidentiality provisions are provided for and authority given to the department to enter into agreements with

other states to assist in the administration of the statute.

The administration expects the following results from the enactment of the Single Business Tax:

- (1) MORE JOBS -- All of the taxes repealed were taxes on capital as opposed to labor inputs into business. Since the Single Business Tax treats capital and labor identically, the heavy burden on capital is lessened, which should encourage job creation and investments.
- (2) MORE STABLE STATE REVENUES FROM BUSINESS -- The yield from the Single Business Tax should closely parallel the course of the economy.

The old taxes dropped sharply in recession periods and expanded rapidly during economic recovery. There will now be less likelihood of more budget deficits followed by periods of excessive surpluses that Michigan has experienced in recent years.

- (3) SOME BUSINESS WILL PAY MORE TAXES AND OTHERS LESS -- All businesses will now be taxed on the same basis. In general, somewhat lower taxes will be paid by most manufacturing, utility, finance, retail and wholesale firms, while higher taxes will be paid by all service industries.

Since the enactment of this tax the department has received numerous questions relative to it from practitioners and taxpayers. The following are the types of questions and answers:

Question: Is a taxpayer who elects to file a combined return required to file combined returns for subsequent years?

Answer: Although there is no language that specifically prohibits "picking and choosing" each year, since Sec. 77 states that "the commissioner may require or permit the filing of a consolidated or combined return" as a matter of policy a taxpayer filing a consolidated or combined return, dependent on the circumstances, if for a subsequent year he elects to change, the commissioner may require the continued filing of a consolidated or combined return, again, dependent on the circumstances.

Question: Is a farm cooperative required to file returns taking into consideration the language of Sec. 35(c)?

Answer: They are required to file a return if they are required to file federal returns, pursuant to Sec. 1381 of the IRC.

Question: Since a partnership has no federal taxable income and is not a taxpayer for federal purposes, is a partnership subject to SBT?

Answer: Yes. A partnership is subject because it is included in the definition of person in Sec. 6 and subject to tax under Sec. 31.

Question: An individual who is in business sells his residence. Is this a casual transaction as defined in Sec. 4(1)?

Answer: Since this transaction is not incidental to his regular business activity it is not subject to SBT. Any gain, of course, would be included in his MI-1040 return.

Question: Does compensation (Sec. 4(3)) include the following:

- a. Commissions paid to manufacturer's representatives  
-No- independent contractor
- b. Gifts to employees - Yes
- c. Reimbursement of employee's expenses - Yes

Question: Which taxes are collected as an agent (Sec. 7(3))?

Answer: As a general rule, if the person is required to remit the taxes regardless of whether or not collected it is not a tax collected in an agency capacity. However, if the tax is not required to be remitted unless collected, the tax is being collected in an agency capacity.

Question: Is interest income from obligations of other states to be included in the SBT tax base?

Answer: It is to be included pursuant to Sec. 9(2) and is not deducted pursuant to Sec. 9(7)(b) since it is not interest included in arriving at federal taxable income.

Question: Explain what taxable assets are eligible for depreciation but would not qualify for the 100% write-off.

Answer: Sec. 23(a) provides a 100% write-off for all depreciable tangible assets except certain depreciable realty defined in Sec. 1250 of the IRS Code. This deduction is multiplied by the average of the payroll and the property apportionment factor. Sec. 23(c) provides a 100% write-off for depreciable real property defined in Sec. 1250 of the IRS Code and located in Michigan. The only depreciable assets not allowed the write-off are real properties located in other states; however, annual depreciation on these assets is included in the tax base at 72% for 1976, 50% for 1977 and 40% for 1978 and thereafter.

- Question: Is Sec. 21 the definition of a financial organization?
- Answer: While there is no specific definition of a financial organization, it is the Department's opinion Sec. 21 defines financial organizations.
- Question: Can a taxpayer reduce his adjusted tax base using more than one of the reductions provided in Sec. 31?
- Answer: No. A taxpayer who qualifies for more than one reduction would, of course, use the one that results in the least tax liability.
- Question: For the purpose of computing the exemption, (Sec. 35(a)), can an individual elect to average his business income based on the four taxable years prior to January 1, 1976?
- Answer: No. This option to compute the exemption will be available beginning with tax years 1977 at which time the business income from 1976 and 1977 may be averaged.
- Question: Do partially completed contracts entered into before September 1, 1975 qualify under Sec. 35(f)?
- Answer: Yes. Compensation expended toward completion of eligible contracts qualify for credit through 1977.
- Question: Can an individual having separate businesses (meat market, grocery and bar) file separate SBT returns (Sec. 37) for each separate business?
- Answer: No. Sec. 6 defines a person as an individual and the SBT is imposed on the adjusted tax base of every person.
- Question: Does the inclusion of fringe benefits in the definition of compensation (Sec. 4(3)) in the tax base affect the wages included in the payroll apportionment factor (Sec. 49)?
- Answer: No. The payroll apportionment factor will continue to include only salaries and wages and will not include fringe benefits such as payments to state and federal unemployment compensation funds, etc.
- Question: Are sales to foreign countries included in the numerator of the sales factor?
- Answer: No, since foreign countries are not included in the definition of "state" in Sec. 52(b).
- Question: Are the first two estimated payments (Sec. 71(3)) required to approximate 50% of the estimated annual liability?

- Answer: Yes. Each payments is to represent 25% of the annual liability.
- Question: Is the option (Sec. 71(8)) to file annual returns before March 1 of the following year to eliminate the requirement for estimated returns available to all taxpayers?
- Answer: No. This method is available to only taxpayers who qualify as farmers and fishermen as provided in the IRS Code.
- Question: Can a fiscal year taxpayer file the final corporate income tax return and the first SBT return using different methods to compute the tax?
- Answer: Yes. This taxpayer can annualize on his final corporate return: e.g., 3-31-76 F/Y using 3/4 of annual tax, and use the actual method provided in Sec. 21 (b) for the first SBT return, or vice versa.
- Question: Will the department (Sec. 76) require the informational form 1099 as is required by the IRC?
- Answer: No.
- Question: What are the appeal procedures?
- Answer: As provided in Sec. 87, a taxpayer can appeal from a notice of intent to assess by requesting an informal conference within twenty days of the notice of intent. The informal conference is similar to our hearing procedures. If the taxpayer is aggrieved by any determination he may appeal to the State Tax Tribunal, or after the payment of the amount due may bring action in the State Court of Claims within 6 months after payment.
- Question: What members of an affiliated group (Sec. 77(1)) can be included in a consolidated or combined return?
- Answer: Only those members that are Michigan taxpayers and, as provided by Sec. 37, the affiliated group is entitled to only one exemption.
- Question: Is failure to file a return (Sec. 101 sufficient to subject a taxpayer to the criminal provisions of the Act?
- Answer: Yes. Failure or refusal to make the return required by this Act, or making false or fraudulent returns with the intention to evade the payment of tax may result in a felony charge. A person who knowingly swears or verifies false statements with the intent to defraud is guilty of perjury and shall be punished in the manner provided by law.
- Question: Does an eligible individual report his land use property tax credit on his MI-1040 or SBT?

Answer: Farmers who are "individual" taxpayers will claim this credit on their MI-1040. Corporate farmers will claim the credit on their SBT return.

Question: The Income Tax Amendatory Act (Act 233, Sec. 269) allows an individual an SBT credit against his income tax liability. If the individual has business income from more than one business (partner in two partnerships) can he combine the net business income from all businesses and the SBT paid to determine the amount of credit?

Answer: Yes. The total business income will be used to determine the percentage to be applied against the SBT paid to determine the amount of SBT credit.

Question: Also, is there a flow-thru of SBT credit to shareholders of subchapter S corporations?

Answer: Yes. The individual will treat the business income from a subchapter S corporation in the same manner that business income from a partnership is treated (see above).

Question: Can a taxpayer use the 52-53 week basis for filing SBT returns?

Answer: Sec. 10(1) provides that "a taxpayer's tax year shall be for the same period as is covered by his federal income tax return."