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**Notice:** Due to the size of the Minutes from the IRS-Bar Liaison Meeting of November, 1985, they are not being published. However, anyone interested in obtaining a copy can get one by writing to the Journal Chairperson:

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February 15, 1986

The editors are pleased to present this Winter issue of the Michigan Tax Law Journal. It is the first one produced by our new staff, which is determined to continue and improve service to our members.

We wish to pass on a comment from Judge Jerome Bronson of the Court of Appeals. In greeting the Section Council members at the Annual Tax Meeting, Judge Bronson complimented the work of the Section and the Tax Bar. He then observed that the Court of Appeals judges come from diverse practice backgrounds and are often not tax specialists. Thus practitioners should strive to simplify and explain technical tax appeals in order to assist judges whose only experience in the tax area is limited to consideration of appeals of tax and tax-related cases. The Appellate practitioners in the Section may wish to reflect Judge Bronson's thoughts, perhaps in light of the widespread and growing Plain English movement.

As always, suggestions, criticisms, potential topics and article manuscripts may be sent to the attention of the Managing Editor, Michigan Tax Law Journal, University of Detroit School of Law, 651 East Jefferson, Detroit, Michigan 48226.

# TAXATION SECTION
# STATE BAR OF MICHIGAN

## COMMITTEE ON PARTNERSHIP TAXATION

## MINUTES OF MEETING
## OCTOBER 2, 1985

Chairman John J. Collins, Jr. called the meeting to order at 8:35 a.m. with George Sokoly acting as Secretary. The following members attended:

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| John J. Collins Jr. | Richard S. Soble |
| Harry M. Eisenberg | George R. Sokoly |
| Mark McGowan | Bruce H. Tobin |
| David J. Ohlgren | |

Chairman Collins reviewed the minutes of the last meeting and asked for current reports from the various chairmen of the subcommittees. John noted that, as of this date, the post of chairperson of the Legislation and Regulation Subcommittee had not yet been filled. This vacancy is particularly important because Congressman Van Der Jagt has informally asked for a response from the committee concerning our review of proposed legislation on partnership taxation. John then mentioned the upcoming joint meeting of the Partnership and Corporate Tax Committees to be held on November 7, 1985, and the Annual Tax Institute to be held on October 17 and 18. He also noted that committee member Steven Fisher's article concerning service partnerships had appeared in the September issue of the Bar Journal. Finally, he announced that a joint meeting of the Taxation and the Real Property Sections of the State Bar had been scheduled for March 5-9 in Tucson, Arizona. The meeting will be devoted to the tax aspects of real estate transactions and the approximate cost will be $1,500 per couple.

Mr. Collins then mentioned that several members of the committee had responded to recent legislative proposals that would put service businesses on the accrual basis. It was suggested that there would probably be relief provisions to avoid bunching of income problems if the proposals are implemented. However, these proposals remain a matter of great concern to members in private practice.

Richard Soble then gave a concise presentation regarding the proposed imputed interest rules that had been passed by the House and were awaiting a vote by the Senate. Rick mentioned that the proposed changes to the imputed interest rules had also been a topic of discussion at our last meeting, but that the version passed by the House would likely be signed by the President. Rick retraced the history of the imputed interest rules beginning with Section 483. In 1984, Congress reacted to the abuses that were created by taxpayers who manipulated interest rates and accounting methods in seller financed real estate transactions. The goal of the imputed interest provisions of the 1984 Act was to prevent taxpayers from mismatching their income and expenses by applying the original issue discount ("OID") rules to these transactions. New Sections 1272 and 1274 of the Internal Revenue Code amended and supplemented Section 483 to raise interest rates to

avoid the imputation of interest, and generally integrated the imputed interest rules into the OID provisions. Rick then discussed briefly the 1984 Act provisions that used the 110% applicable federal rate (the "AFR") as the testing rate and the 120% AFR imputation rate. He noted several exemptions to the application of Section 1274 that were to be regulated by revised Section 483. Rick then described the ensuing uproar from the legal and accounting professions that led to the interim remedial legislation passed in late 1984. This legislation was designed to delay the application of certain sections of the 1984 Act and provide certain relief in the small transactions area. The remedial legislation expired June 30, 1985, and Congress has been attempting to finalize a permanent imputed interest simplification act.

Rick next described some of the in-fighting that led to the current bill passed by the House. Rick noted key provisions of the pending legislation, including the elimination of separate testing and imputation rates, which would apply retroactively to July 1, 1985. Transactions will now be tested for computed interest using a single testing and imputation rate of 100% of the AFR. There will be special provisions for transactions involving less than $2.8 million in debt. These provisions will utilize testing and an imputation rate that will be no greater than the lesser of 100% of AFR or 9% compounded semi-annually (9.2% simple interest). Sales and leasebacks are subject to a special 110% AFR testing and imputation rate. The AFR will continue to be published on a monthly basis by the IRS as was done under the remedial legislation. Basically, taxpayers will have a choice of choosing either the AFR for the month in which the transaction occurred or the rate for the two preceding months prior to the transaction. The proposed legislation provides that interest rules will not now apply to assumptions of debt unless the underlying debt is in some way modified by the transaction. However, wrap-arounds are not treated as assumptions under the proposed legislation. Rick commented that in a wrap-around transaction, the OID rules will apply to all debt, including the so-called assumption of debt, and that the committee reports will specifically not endorse the Hunt case. Rick noted that in another exemptive provision for small transactions, in transactions not exceeding $2,000,000 in principal amount, if sellers are on the cash basis method of accounting, purchasers generally can elect to use the cash basis method of accounting. This was a significant departure from the 1984 Act.

A general discussion then ensued concerning problems with the implemention of the transitional rules and the proposed "Simplification Act."

The next committee meeting was scheduled for December 4, 1985, at Mark McGowan's office at 900 Marquette Building, Detroit 48226. Mark has consented to conduct a short presentation on current aspects of equipment leasing.

There being no further business, the meeting was adjourned.

Respectfully submitted,

George R. Sokoly

**TAXATION SECTION**
**STATE BAR OF MICHIGAN**

**COMMITTEE ON PARTNERSHIP TAXATION**

**MINUTES OF MEETING**
**DECEMBER 4, 1985**

A meeting of the Partnership Committee of the Taxation Section State Bar of Michigan was called to order at 8:35 a.m. on December 4, 1985. The meeting was held in the offices of Plunkett, Cooney, Rutt, Watters, Stanczyk & Pedersen, P.C. with Mark McGowan acting as host. Present were the following members:

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|---|---|
| Gary Bruhn | Mark McGowan |
| John Collins | Kathleen Williams Newell |
| Harry Eisenberg | David Ohlgren |
| Larry Elkus | Loren Opper |
| Paul Garvey | John Young |
| John Grant | Steve Young |

John Collins announced that effective this meeting he was being replaced as Chairman of the Committee by Mark McGowan. John Grant was appointed Chairman of the Subcommittee on Legislation and Regulations.

Mr. Collins noted that the Winter Real Property Conference, jointly sponsored by the Real Property Law and Taxation Sections of the State Bar, is scheduled to be held in Tucson, Arizona from March 6 through March 8, 1986, and will deal with tax aspects of real estate transactions and syndications.

The Committee discussed the format for the Annual Federal and State Tax Institute presented by the Institute of Continuing Legal Education in conjunction with the Taxation Section. Some members stated that the Institute should be moved from the fall to springtime and that perhaps more emphasis should be placed on state and local tax. The possibility of a workshop format was also mentioned.

Mark McGowan gave a detailed presentation on tax aspects of equipment leasing transactions. He identified the tax issues for structuring the transaction, and for advising clients on whether to invest in such an investment. Mark handed out a 15 page outline covering the topic and went through various points in the outline in detail.

The next meeting of the Partnership Committee was scheduled to be held on Thursday, March 13, 1986 at the Bloomfield Hills office of Miller, Canfield, Paddock and Stone. The meeting will commence at 8:30 a.m. Larry Elkus agreed to discuss tax aspects of oil and gas investments. He will give particular attention to problems unique to oil and gas investments, but also will address tax considerations of recourse and nonrecourse financing, and application of the at-risk and basis rules in partnership transactions. Gary Bruhn and George Sokoly volunteered to present a primer on the federal and state securities aspects of

partnership transactions at the next Committee meeting, to be held later in the spring of 1986.

The meeting was adjourned at 10:05 a.m.

Respectfully submitted,

John J. Collins, Jr.

# FOREIGN PARTNERSHIP - TRUST'S ALLOCATION AND APPORTIONMENT OF INCOME/LOSSES TO MICHIGAN DOMICILED BANK-PARTNER'S INCOME

By: Michael J. Kowal

## I. INTRODUCTION

The movement away from the proscription against taxation of nondomiciliary banks for their in-state activity began in 1969, leaving to the states various methods of apportioning income and losses.[1] Concurrently, the historical separation of banking and commerce blurred, leading to a broader range of financial services that are held to be within the business of banking.[2] One way for a bank to be involved in interstate business is through a leverage lease agreement in which a domiciled bank becomes a partner in an out-of-state partnership-trust.

This article examines the relationship of the trust to the bank/partner for Michigan income tax purposes in light of The Detroit Bank and Trust Company v Michigan Department of Treasury, 145 Mich App 327, 377 NW 2d 425 (1985). The Court of Appeals rejected appellant's argument that the partnership-trusts were separate and distinct entities for tax purposes and found that the partnership-trusts were an extension of a bank's regular trade or business of investing and financing. Petitioner bank was entitled to deduct the partnership-trust's losses from its Michigan income.

## II. BACKGROUND

The complexity of leverage lease transactions, popular for financing large capital equipment projects, requires considerable expertise. In a leverage lease situation, a company in need of financing (the lessee) having decided what to purchase, approaches a participating financial institution (the lessor) to buy the necessary goods. The lessor purchases the equipment and then leases it to the lessee. Through the leverage lease agreement, the lessee conserves capital and at the same time is allowed to deduct lease payments for tax purposes. The lessor enjoys accelerated depreciation, investment tax credits, deduction of interest paid to long term lenders, and any residual value of the equipment.[3] Developing a leverage lease may require the participation of a number of financial institutions if the amount of money needed is very large. This leads to "participation agreements" such as a partnership-trust.

For federal income tax purposes, equity lenders of leased equipment are generally considered to be the owners of the equipment and, as such, are entitled to subsequent tax benefits. Accordingly, the trust formed by the equity lenders is considered to be a partnership, not a taxable corporation. Each partner's federal taxable income includes distributive adjustments due to the trust's profits and losses. MCLA 206.2(3); MSA 7.557(102) states that the income taxable in Michigan is the same as the federal taxable income, unless otherwise provided in the Income Tax Act.[4]

While it was not specifically argued to the trial or appellate court, appellant Department of Treasury, in the Detroit Bank and Trust case, sought to construe the Income Tax Act of 1967, MCLA 206.1, et seq; MSA 7.557, et seq,[5] as providing a different tax treatment for Michigan domiciled banks involved in out-of-state partnership-trusts than that provided for in the Internal Revenue Code. The Department of Treasury had not pursued this position with any other bank in a similar situation and thus the issues raised were of first impression.

The department argued that the partnership-trust, formed in Utah to hold title to certain leased trains, was a separate and distinct business from the bank. Therefore, MCLA 206.115; MSA 7.557(1115)[6], it argued, was the appropriate allocation section for the trust's profits/losses. Section 115 uses a formula apportionment method, consisting of sales, payroll, and property factors. In Detroit Bank and Trust, these totaled zero because, as separate entities, the trusts had no sales, property, or payroll in Michigan.

In support of calling the trusts separate and distinct entities, the department noted that: (1) the trusts had no offices, records or property in Michigan; (2) the trusts were governed by Utah law and the trustee was charged with preparing and filing of federal information returns for the trusts;[7] (3) the bank and the trusts had different employer numbers and indicated different principal business activities (finance as opposed to equipment leasing) on their federal information returns; and (4) although the Utah trusts were engaged in a single trade or business with the bank, the bank was only a partner. The department contended that the partnership's activities were separate and distinct from those of the bank and that the losses should be apportioned to Utah, and could not be used to reduce the bank's Michigan income tax. Petitioner bank agreed with the department that the trusts were separate entities from the bank, but disagreed with the department's treatment of the trusts under the 1967 Act.

The department argued further that as a separate and distinct entity, the trust was a "person" under MCLA 206.16; MSA 7.557(116)[8], and a "taxpayer" under MCLA 206.26; MSA 7.557(126)[9]. Therefore, the trusts were subject to the apportionment factors of MCLA 206.115; MSA 7.557(1115). In other words, the trust's losses were attributable entirely outside of Michigan, following the Court of Appeals decision in Grunewald v Department of Treasury, 104 Mich App 601; 1305 NW 2d 269 (1981).

In Grunewald, two Michigan attorneys were involved in a limited partnership in Pennsylvania that operated an apartment complex. The partnership sustained losses which the attorneys deducted from their Michigan taxable income. The Court of Appeals held that the losses were attributable to Pennsylvania and could not be used to reduce the partners' Michigan income tax. The department argued that even if the statutory ban on taxation of non-domiciliary banks for their in-state activity, PL 93-100, 87 STAT 342, 18 USC 1932,[10] were in effect, Utah would still have the jurisdiction to tax profits of the Utah trust. In order to apply section 115 to the bank's distributive share of losses, it was important to label the trusts as distinct and separate entities because the section does not apply to financial organizations.

"Financial organization" is defined by MCLA 206.10(3); MSA 7.557(110)(3). "Financial institution" is defined by MCLA 206.10(2); MSA 7.557(110)(3). Banks are clearly financial institutions under the act and, pursuant to MCLA 487.335; MSA 23.710(35), MCLA 487.451; MSA 23.710(151), are forbidden to participate in non-banking or unrelated activities. The only attribution provision for financial organizations which are partly engaged in out-of-state income producing activity is MCLA 206.151; MSA 7.557(1151)[12]. The bank used this section in computing its percentage of income attributable to income from its London office. The department did not challenge the attribution figures which imply that the trusts' losses were attributable to Michigan and not out-of-state. These, as well as other factors, refuted the department's position that the trusts and the bank were separate and distinct entities for tax purposes and not a flow through device for the partners.

In addition, the bank argued:

1. Federal laws and regulations prohibit a bank from engaging in non-banking activities. Section 115 applies to non-financial activities which are forbidden to a bank.

2. Participation agreements are common in leverage leasing as a means of financing large capital equipment projects at the lessee's request. In fact, 25 percent of the bank's commercial loans were out-of-state.

3. Regular or trade business in banking means any deployment of funds permissible under law and regulations. Financing, in banking parlance, includes lending and leasing.

4. The department treated previous participation agreements, those not involving partnerships, pursuant to Section 151. The IRS granted a letter ruling, commonly sought prior to formalizing the leverage lease agreement, to insure that the benefits of such a transaction would be forthcoming. The letter ruling provided that the trusts would be regarded as a partnership. Each partner held its distributive share. Deductions were allowed. The partners were the equity owners of the equipment, and the transaction was a true lease. Generally, Michigan taxable income equals federal taxable income. MCLA 206.2(3); MSA 7.557(102). The bank, therefore, had no reason to expect different treatment for a participation agreement involving partnership-trusts.

5. In a similar transaction in Michigan by a foreign bank, Michigan could not tax the out-of-state partners or trusts and the lessee and leased property would not be regulated by the Michigan Financial Institutions Bureau.

6. Grunewald, supra, is distinguished from the case here. The ban on taxing non-domiciliary banks was not an issue in Grunewald since Pennsylvania could tax the income. The case involved individuals, not a financial organization. Each different entity is taxable at different rates and subject to different taxing provisions. In Grunewald, the taxpayer clearly engaged in separate and distinct activity.

7. The department made the same argument in the Old Kent Financial matter before the same referee, who rejected it in both Old Kent (which was settled) and in Detroit Bank. The referee in Old Kent, a mirror image of the present one, conceded that the arguments for disallowing the deductions were not as persuasive or as well founded on sound doctrines of statutory construction as the plaintiff's position in that case, which is the petitioner bank's position here.[13]

8. The definition of "person" in MCLA 206.16; MSA 7.557(116) does not specify partnership. Tax provisions are not extended beyond matters not "specifically pointed out."[14]

9. Finally, the department never approved an alternative method of allocation and apportionment as provided in MCLA 206.195; MSA 7.557(1195).[15] Nor did petitioner bank ever utilize this section. Therefore, other sections must be used to determine petitioner's income.

The tax tribunal, which was affirmed by the Michigan Court of Appeals, held that the partnership-trust was not a "taxpayer" or "person" per the literal language of the act, but rather an extension of the bank's regular trade and business. Further, the court said that in no way, other than the partnership being excluded from corporate taxes, did the trusts take on partnership identity. Therefore, a Michigan domiciled bank engaged in a leverage lease through a foreign partnership-trust is entitled to deduct trust losses from its Michigan income. The activities of the trusts are not separate and distinct from those of the bank/partner.

## III. ASSESSMENT OF PRESENT STATE LAW

A financial institution domiciled in Michigan and engaged in an out-of-state partnership-trust as part of a leverage lease agreement during the years covered by the Income Tax Act of 1967; MCLA 206.1, et seq; MSA 7.557(1), et seq (expired in 1975) correctly apportions all the trust's profits or losses to its Michigan income pursuant to section 151. The partnership-trust, although technically a separate and distinct entity, is within the trade or business of a bank. The institution may deduct the partnership's losses in order to reduce its Michigan income tax.

Changes in both federal and state tax laws are important to consider in determining whether the outcome of the Detroit Bank and Trust case is valid for similar transactions engaged in since 1975. The moratorium of taxation on banking activity conducted outside the home state expired on January, 1, 1976.[16] While the states continue to search for equitable means of allocating and apportioning income derived from interstate activity, there seems to be no indication of a similar ban being issued in the near future.

The Michigan Single Business Tax Act, MCLA 208.1 et seq; MSA 7.557(1), et seq; replaced the financial institution provisions of the Income Tax Act of 1967, MCLA 206.1, et seq; MSA 7.557(1), et seq, which were repealed by 1975 PA 233. The act now applies only to individuals, estates, and trusts. Under the Single Business Tax Act, the definition of "person" specifically includes partnerships. MCLA 208.6; MSA 7.558(6). Partnerships are taxable entities. While the distributive share of profits are not taxable under the Single Business Tax Act, they are taxable to the partners under the 1967 Act.

## IV. CRITIQUE AND ANALYSIS

Partnerships, while treated differently for some purposes, are held to be within the bank's business or trade when used to hold title to leased personal property. The Detroit Bank and Trust Company v Department of Treasury, 145 Mich App 327; 377 NW2d 425 (1985), reh den, (October 25, 1985). The department in Detroit Bank and Trust sought to have the partnership's activity construed as separate and distinct from that of the bank and therefore allowed apportionment and allocation pursuant to Section 115. This was not allowed because the partnership was not taxable under the literal language of the act.

Although other courts have held that leasing personal property as a form of securing the transaction was within the banks enumerated/incidental powers, M & M Leasing Corp v Seattle First National Bank, 563 F2d 1377 (CA 9, 1977), the court in Detroit Bank and Trust is leading the law in deciding, at least for Michigan, that leasing activities by a separate and distinct foreign entity (the partnership) which owns the property, are not distinct from the bank/partner's trade or business.

Under the Single Business Tax Act, MCLA 208.1, et seq; MSA 7.557(1), et seq, partnerships are taxable entities and Section 42 (the equivalent to Section 115), MCLA 208.42; MSA 7.558(42), is applicable. As a taxable entity engaged in an out-of-state business (i.e., leasing), its allocation and apportionment is determined by the sales, payroll, and property factors. But the strict application of this treatment

may not have been so clear, in light of the Detroit Bank holding that the partnership's activities were a part of the bank/partner's regular trade or business, were it not for another recent case decided by the Court of Appeals. Wismer & Becker Contracting Engineers v Michigan Department of Treasury, No. 81744, slip op (Mich App Ct, November 1, 1985).

In Wismer, the "unitary business" concept was discussed in relation to the Single Business Tax Act. A unitary business is one in which its various parts are interdependent and form one business unit. The court stated that the only relevance of the unitary concept to the Single Business Tax Act is as a tool to decide whether the exceptional relief of separate accounting under Section 69, MCLA 208.69; MSA 7.668(69) (the equivalent provision of Section 195 of the 1967 Act) is appropriate. It should not be used to decide whether interdependent business entities are one or more taxpayers under the act. The legislature expressly determined that question in the act.

## V. CONCLUSION

There is a growing trend for financial institutions to engage in interstate business transactions. The state's desire to tax these income producing activities led to various apportionment and allocation methods for the income. Controversies developed over the proper allocation and apportionment of a foreign partnership's income/losses to an in-state bank-partner involved in a leverage lease agreement. In Detroit Bank and Trust v Michigan Department of Treasury the Michigan Court of Appeals held that a partnership is not a taxable entity pursuant to the Income Tax Act of 1967, and that the partnership's activities were an extension of the bank/partner's regular trade or business. Subsequently, the bank's distributive share of losses can be deducted to reduce Michigan income tax.

Since the advent of the Single Business Tax Act and the expiration of the moratorium on taxing a non-domiciliary bank, the foreign partnerhsip-trust's profits/losses would ordinarily be allocted pursuant to Section 42. MCLA 208.42; MSA 7.558(42). This would deprive the bank/partner of some of the tax advantages of the leverage lease agreement such as deducting the losses commonly expected during the early period of the lease. The court in Detroit Bank and Trust may have opened a door for an exception to applying Section 42 to a partnership whose sole function is to hold title for bank-partners in a leverage lease agreement. The partnership, while a separate taxable entity, is merely an extension of the bank-partner's regular trade, and business, and arguably should be allocated/apportioned pursuant to Section 65 (the equivalent provision of Section 151 of the 1967 Act), MCLA 208.65; MSA 7.558(65). Thus, the favorable tax consequences of a leverage lease agreement may have been preserved under the Single Business Tax Act. But this possibility seems to have been extinguished by Wismer & Becker Contracting Engineers v Michigan Department of Treasury where the court said that an exception of the Act for unitary business does not exist. Subsequently, it may be inadvisable for a bank to enter into a partnership as part of a leverage lease agreement if it wishes to take full advantage of the favorable tax consequences available through a leverage lease transaction.

## NOTES

1. For a full discussion see Levinson, Interstate Taxation and Apportionment of Bank Income, 34 Nat'l Tax J 447 (1981).

2. Symons, The "Business of Banking" in Historical Perspective, 51 Geo Wash L Rev 676 (1983).

3. Comptroller's Handbook for National Bank Examiners.

4. MCLA 206.2(3); MSA 7.557(102): "It is the intention of this act that the income subject to tax be the same as taxable income as defined and applicable to the subject taxpayer in the internal revenue code, except as otherwise provided in this act."

5. The Income Tax Act of 1967 is still in effect but it is limited to individuals. All other taxable entities fall under the Single Business Act of 1975. MCLA 208.1, et seq; MSA 7.558(1), et seq.

6. MCLA 206.115; MSA 71557(1115): "All business income, other than income from transportation services, domestic insurers and financial organizations, shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

7. The trustee's charge was not pursuant to MCLA 206.341; MSA 7.557(1341): "Any voluntary association, joint venture, partnership, estate or trust, at its option and its election, under rules prescribed by the department, may file a return, compute and pay the tax which is due with respect to the distributive shares of the income of the business. The return shall be entitled to only one personal or dependency exemption. The tax thus paid shall constitute all tax due with respect to each distributive share."

8. MCLA 206.16; MSA 7557(116): "'Person' includes any individual, firm, association, corporation, receiver, estate, trust of any other group or combination acting as a unit, and the plural as well as the singular number."

9. MCLA 206.26; MSA 7.557(126): "'Taxpayer' means any person subject to the taxes imposed by this act or any employer required to withhold taxes on salaries and wages."

10. PA 93-100 sec 7(c) (expired 9/12/76): ". . . no state or political subdivision thereof may impose any tax measured by income or receipts or any other 'doing business' tax on any insured depository not having its principal office within such state."

11. MCL 206.10(2) and (3); MSA 7.557(110): "'Financial Institution' means any bank, trust company, building and loan or savings and loan association or industrial bank"; 'Financial organization' means a bank, industrial bank, trust company, . . . at least 90 percent of whose gross income consists of dividends or interst of other charges resulting from the use of money or credit."

12. MCLA 206.151; MSA 7.557(1151): "The taxable income of a financial organization attributable to Michigan sources shall be taken to be: (b) In the case of taxable income of a taxpayer who conducts income-producing activities as a financial organization partially within and partially without this state, that portion of its net income as its gross business in this state is to its gross business everywhere during the period covered by its return, which portion shall be determined as the sum of: (i) Fees, commissions or other compensation for financial services rendered from the operation as a financial organization within this state, divided by the aggregate amount of such items of the taxpayer everywhere."

13. See referee's comments quoted in The Detroit Bank and Trust Company v Michigan Department of Treasury, 145 Mich App 327; 377 NW2d 425 (1985).

14. Hart v Department of Revenue, 333 Mich 248, 252; 52 NW2d 685 (1952) (quoting Gould v Gould, 245 US 151, 153; 38 S Ct 53; 62 L Ed 211 (1917)). "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen."

15. MCLA 206.195; MSA 7.557(1195): "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) separate accounting; (b) the exclusion of any one or more of the factors; (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's taxable income. An alternative method will be effective only with approval by the commissioner."

16. PL 93-100, 87 STAT 342, 18 USC 1832.

17. MCLA 208.6; MSA 7.558(6): "(1) 'Person' means an individual, firm, bank, financial institution, limited partnership, copartnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit."

# GOVERNOR BLANCHARD'S PROPOSED TAX REFORM FOR MICHIGAN

By: Thomas J. Tomko

## I. INTRODUCTION

The State Senate is currently considering a tax reform plan devised by Governor James Blanchard. The Governor's Tax Plan (hereinafter, the Tax Plan) was introduced into the State House as HB 4699 through HB 4709 and HB 4820.[1] These bills were passed in the House in late June and early July of 1985. The Tax Plan proposes changes in the taxation of personal income, financial institutions, insurance companies, and a small group of other areas.

The purpose of this article is twofold: Firstly, to provide an overview of the details and consequences of the various aspects of the proposed Tax Plan; and secondly, to summarize the major arguments for and against the Tax Plan, as advanced by the Michigan legislature, the Department of Treasury, the Michigan Chamber of Commerce, and miscellaneous special interest groups.

## II. PROPOSED CHANGES IN MICHIGAN TAX LAW

### A. Income Tax Provisions

SB 340 (HB 4699) proposes changes in the Homestead Property Tax Credit, Capital Gains Tax, Lump Sum Distributions Tax, Personal Income Tax Rate and Personal Income Tax Exemptions. The House passed HB 4699 on June 24, 1985 and sent it to the Senate Finance Committee as SB 340 on June 28, 1985.

#### 1. Homestead Property Tax Credit

Homeowners currently have a tax credit available for up to 60% of the property tax paid that exceeds 3.5% of household income. MCL 206.522; MSA 7.557 (1522). Senior citizens have an available credit of 100% of property tax paid to the extent that it exceeds 3.5% of household income. But if household income is less than $6,000, the available credit for senior citizens is listed in a schedule. MCL 206.522(1)(b); MSA 7.557 (1522) Sec. 522(1)(b). Renters currently have an available tax credit equal to 17% of rent paid which exceeds 3.5% of household income. MCL 206.522; MSA 7.557 Sec. 1522.

SB 340 (HB 4699) proposes to increase the available credit to homeowners, senior homeowners, and renters by lowering the percentage rate multiplied by household income from 3.5% to 3.0%. Scheduled deductions for senior citizens would apply only if the senior citizen earns less than $5,000. The applicability of the schedule of credits would be expanded to include disabled persons. SB 340, p10; (HB 4699, p10).

2. Capital Gains Tax

Long-term capital gains are currently taxed in Michigan to the same extent that the Internal Revenue Code of 1954 taxes them.[2] Adjusted gross income includes 40% of net long-term capital gains.[3] The change proposed in SB 340 (HB 4699) treats 100% of net long-term capital gains as part of adjusted gross income. In addition, SB 340 (HB 4699) proposes to limit the allowable net capital loss for any one tax year to $3,000. SB 340, p5; (HB 4699, p5).

3. Lump Sum Distributions Tax

The Internal Revenue Code of 1954 allows a taxpayer to elect to exclude lump sum distributions from adjusted gross income and pay an alternative tax on the distribution.[4] Michigan does not have an alternative tax for lump sum distributions electively excluded from adjusted gross income. Michigan law does not require that excluded lump sum distributions be added back into adjusted gross income for Michigan tax purposes. Taxpayers electing to pay alternative taxes on lump sum distributions for Federal tax purposes shelter lump sum distributions from Michigan income tax.

The Michigan tax change proposed in SB 340 (HB 4699) requires lump sum distributions electively excluded from the Federal calculation of adjusted gross income to be added back into adjusted gross income for Michigan tax purposes. The proposed change also creates a lump sum distribution exemption for taxpayers filing single and joint returns of $7,500 and $10,000, respectively. SB 340, p4-5; (HB 4699, p4).

4. Personal Income Tax Rate

Michigan taxes adjusted gross income at 5.10%. This is a reduction from the 5.35% rate in effect prior to November 8, 1985, when the state's budget deficit was eliminated. On October 1, 1987, this rate will be reduced to 4.6%. MCL 206.51; MSA 7.557 (151). Governor Blanchard's tax package proposes to reduce the tax rate to 4.6% on June 30, 1986. SB 340, p6; (HB 4699, p6).

As an alternative to the Democratic rollback, the Michigan Senate passed SB 77 in February 1985. This bill proposes to reduce the personal income tax rate to 4.6%, effective on January 1, 1986, SB 77, p2.[5]

5. Personal Income Tax Exemptions

Michigan's personal tax exemption has been $1,500 since 1974, MCL 206.30; MSA 7.557 (130). Governor Blanchard's tax reform proposal originally included an increase in the personal tax exemption to $1,700. The Michigan House of Representatives passed this proposal, only after reducing the personal tax exemption back to $1,500. SB 340, p5 (HB 4699, p5).

The Michigan Senate proposed and passed SB 59 which would raise the personal tax exemption to $1,750. SB 59 proposes that this exemption be adjusted each year according to an index which would reflect changes in the inflation rate. SB 59, p5.

B. Financial Institutions

1. Temporary Increase in Intangibles Tax

One of the purposes of Michigan's Single Business Tax was to exempt interest earned by financial institutions on state and local obligations, and to tax interest earned on federal obligations. In Memphis Bank & Trust Company v Garner, 459 US 392; 103 SCt 692; 74 L Ed 2d 562 (1983), the Court held that this type of statutory tax scheme was not enforceable. Relying on 31 USC 742 the Supreme Court stated that "holders of federal property and those with whom the Federal Government deals" are discriminated against under dual classification tax statutes. Memphis Bank at 397.

The intent of SB 341 (HB 4700) and SB 342 (HB 4701) is to tax financial institutions on deposits held at federally insured banks. This new tax would recover what would have been realized in tax revenues had the Memphis Bank decision not invalidated Michigan's Single Business Tax on interest from federal obligations. Deposits of financial institutions held in federally insured banks would be taxed at a rate of $1.50 per $1,000 of deposits in 1985 and 1986. SB 341, p3; (HB 4700, p3). The total tax that any one bank would pay over these two years would be limited to a total of 55% of the taxes refunded or deducted due to the Memphis Bank decision. SB 341, p3; (HB 4700, p3). Other financial institutions would be limited to paying an aggregate intangibles tax equal to the total amounts refunded or deducted due to Memphis Bank. SB 342, p2-3, (HB 4701, p2-3).

2. Permanent Increases in the Intangibles Tax

Deposits of banks and paid-in value of shares in building and loan or savings and loan associations are taxed in Michigan at a rate of 20 cents per $1,000. MCL 205.132; MSA 7.556 (2). SB 341 (HB 4700) proposes to change this rate to 40 cents per $1,000. SB 340, p3; (HB 4700, p3).

C. Insurance Companies

1. Premiums Tax on Michigan Insurance Companies

Michigan currently taxes premium earned by insurance companies organized under the laws of other states at 2% or 3%, depending on the premium classifications. MCL 500.400; MSA 24.1440. Michigan based insurance companies pay taxes on premiums as prescribed by the Michigan Single Business Tax.[6] In Metropolitan Life v Ward ___ US ___; 106 SCt 1905; 84 L Ed 2d 751 (1985), the Court held that states cannot tax in-state and out-of-state insurance companies differently when the purpose of the disparate treatment is to promote the development of in-state insurance companies. Metropolitan Life at 754. This decision may invalidate Michigan's current differential tax scheme. (See discussion p13).

Proposed tax reform bills SB 343 (HB 4702) and SB 344 (HB 4703) tax both Michigan based and non-Michigan based insurance companies at the 2% and 3% levels now applied only to non-Michigan based insurance companies.[7]

2. Health Insurance Contracts

Administrative Services Only contracts (ASO's) are taxed under the Michigan Single Business Tax by legislation exempting them from the Premiums Tax. MCL 780.101 to 780.106, 780.108; MSA 28.1286(1) to 28.1286(6), 28.1286(8). Current data suggests that the taxing of ASO's under the SBT results in premiums being taxed at less than 2%. SB 343 (HB 4702) and SB 345 (HB 4704) propose to tax ASO premiums under the Premiums Tax which would result in a flat 2% rate.[8]

D. Other Provisions

1. Computer Software Tax

The Michigan Department of Treasury interpreted the Use Tax Act as taxing all computer software. MCL 205.91 et. seq.; MSA 7.555 (1) et. seq. In Macabees Mutual Life Insurance Company v Department of Treasury 122 Mich App 660; 332 NW 2d 561 (1983), the Court held that the statute did not effectively tax computer software modified and adapted for a user, or computer software specifically designed and developed for a user. Macabees Mutual at 666.

Proposed bills SB 349 (HB 4708) and SB 350 (HB 4709) expand the Michigan Use Tax to include additional computer software. The new definition of taxable computer software would include canned computer software, and modified or adapted computer software that is offered for general public use and classified as tangible personal property.[9]

2. Tax Amnesty

In the last week of September 1985, the Michigan Senate passed SB 347 (HB 4706) and SB 348 (HB 4707). These bills create an amnesty period of 45 to 60 days in which taxpayers owing back taxes can pay the taxes without incurring penalties (interest must still be paid). SB 347, p18-19; (HB 4706, p18-19). Upon expiration of the grace period, substantial penalties accrue to taxpayers who have not paid their delinquent taxes during the amnesty period. SB 347, p9; (HB 4706, p9). Additionally, the Michigan Department of Treasury is given broader powers to enforce collection of delinquent taxes. SB 347, p12, 16, 17; (HB 4706, p12, 16, 17).

3. SBT Credits to Telephone Companies

Michigan's Single Business Tax Act currently allows telephone companies to claim a tax credit equal to the Michigan tax on real and personal property. MCL 208.39; MSA 7.558 (39). HB 4820 proposes the elimination of this tax credit for Michigan telephone companies. HB 4820, p1-2.

## III. CRITICISMS AND SUPPORT FOR PROPOSED TAX CHANGES

The Governor's tax reform proposals are supported generally by House Democrats and the Michigan Department of Treasury. House Democrats are traditionally in favor of increasing tax revenues which would support and expand the operation of social programs. The immediate concern of the Michigan

Department of Treasury is to keep the state budget balanced. Secondary concerns include administrative ease of tax programs and equal tax treatment.

Senate Republicans, the Michigan League of Savings and Loans Institute, and the Michigan State Chamber of Commerce generally oppose the Governor's tax reform proposals. The Michigan League is concerned with the stability of banking in Michigan. Republicans and the State Chamber of Commerce are troubled by the shift in the tax burden that the Tax Plan would bring, and the long-term business environment in Michigan. The following sections highlight the major concerns of groups in support of and opposed to the Governor's tax proposals.

A. Income Tax Provisions

1. Home Property Tax Credit

Michigan homeowners and renters pay property taxes which are among the highest in the nation. The proposed property tax credits would save some 500,000 families approximately $150 million in taxes.[10] This reduction in property taxes will aid all homeowners, especially senior citizens who are on fixed incomes and often have cash-flow problems as a result of property tax increases caused by inflation. The Michigan League of Savings and Loans Institute has long supported broad property tax relief and supports this tax reform bill. They support this tax credit because the housing market is often more attractive to potential buyers when taxes are lower. The inverse relationship between taxes and home prices will also tend to increase the overall price level of housing in Michigan, increasing the mortgage amount that home purchasers will borrow. Michigan lending institutions also support this reduction because it will increase borrowing activity by homeowners and potential homeowners. Property owners will also be benefited by paying less in taxes and having more income.

The Senate Republicans and the Michigan State Chamber of Commerce oppose the reduction in property taxes. Subsidizing property taxes with a tax credit does not reduce the level of property taxes. An incentive exists for municipalities to increase property taxes due to this subsidization. Businesses would not receive the credit, and would bear disproportionately any additional property tax compared with individual homeowners. In a sluggishly expanding Michigan economy, a long-run disincentive for business activity could pose serious economic development concerns.

Senate Republicans offer a counter proposal to this aspect of the Governor's Tax Package in SB 569, SB 570 and SB 571. These bills propose tax credits which would apply only to senior citizens. The Senate passed these bills in early November of 1985. Senior citizens would receive a 50% tax credit for 1986 property taxes paid, and a scheduled increase in credits through 1991 when a 100% tax credit would tax effect. These proposed bills address the problems of fixed income property taxpayers and avoid some of the problems of the broad approach in the Governor's Tax Plan.

The Michigan State Chamber of Commerce supports a more direct property tax relief approach. The Governor's proposed tax reform disproportionately gives the bulk of its relief to homeowners earning over $40,000 per year.

His plan is recognized as having distorting effects because it is a tax credit and not a form of tax relief. Likewise, the Senate proposal, also a tax credit, is criticized for only addressing senior citizens' taxes and not those of other homeowners, renters, and businesses. The Chamber of Commerce believes that these approaches are cosmetic and need to be addressed more directly.

2. Capital Gains Tax

House Democrats support this portion of the Governor's tax plan because of the potential additions to revenue that this tax will generate. The policy behind increasing the tax on capital gains is that it is improper to tax wages and salaries at a higher rate than capital investment income.

Senate Republicans oppose this bill. They assert that venture capital will flow away from Michigan. The likely short-term increase in tax revenues from the proposed tax may be significantly offset by decreases in capital investment in Michigan. The Chamber of Commerce opposes this bill reasoning that additional tax revenues are not needed since Michigan's budget deficit has been eliminated.

3. Lump Sum Distributions Tax

House Democrats who support this tax change note that the current exclusion of lump sum distributions from Michigan tax is a legislative oversight. They assert that it was never the intention of law makers to exclude these distributions from Michigan tax.

Senate Republicans feel the Governor's proposed change will encourage retirees to leave Michigan. They believe that a temporary increase in tax revenues will be offset by the loss of inheritance and intangible taxes as retirees move out of Michigan to avoid the tax penalties imposed by the new Tax Plan.

4. Personal Income Tax Rate

Both the House and Senate support a reduction in the personal income tax rate. This dispute focuses on timing. The May rollback to 4.6%, proposed by House Democrats as part of the Governor's tax plan, would provide a surplus in the state budget. House Democrats feel that a surplus could offset cutbacks in federal programs and provide a buffer for a possible recession in 1986.

House Republicans, the Michigan Merchant's Council, and the Michigan State Chamber of Commerce all support an earlier rollback of the tax rate in Michigan. They feel the Senate's January 1986 rollback plan will create healthier business climate and give Michigan taxpayers more disposable personal income sooner. Senate Republicans project that by December 31, 1985, Michigan will have a $452 million surplus in its budget. The original increase in the tax rate to 5.1% was intended as a shortrun solution to a temporary problem of balancing the budget. Since that goal has been reached, no reason exists to delay a tax rollback.[11]

5. Personal Income Tax Exemptions

The personal income tax exemption in Michigan has not been changed since 1974. The House and Senate generally support some form of increase in this exemption. Inflation has decreased purchasing power by over 50% since 1974 and an adjustment would help to bring this measure in line with inflation. House Democrats support a reduction to a fixed level of $1,700.

Senate Republicans have countered this proposal by passing SB 59, which would raise the personal exemption to $1,750 and index it to inflation. The Senate bill will encounter less political opposition than the Democratic bill because it is not tied to any other proposed tax changes. In order for the Democratic bill SB 340 (HB 4699) to be enacted, SB 341 through SB 350 would also have to pass in the Senate.

B. Financial Institutions

1. Temporary Increase in Intangibles Tax

House Democrats and the Michigan Department of Treasury support the portion of the Governor's tax proposals that would recapture tax revenues foregone due to the Memphis Bank decision. They believe the Memphis Bank decision gave a "windfall" to financial institutions which received Michigan tax refunds due to the ruling. Proponents of this temporary tax also cite Michigan Department of Treasury statistics which indicate that the ten largest banks in Michigan paid 25% less in 1983 state taxes than they did in 1974.[12]

The Michigan Bankers Association reviewed the figures relied upon by the Department of Treasury and concluded that the figures used were erroneous. The Michigan Department of Treasury adjusted its figures to match those supplied by the Michigan Bankers Association. Computations involving the new agreed upon figures result in similar conclusions when comparing 1974 and 1983. In 1984 though, taxes paid by financial institutions were 40% greater than that paid in 1974.[13] Differences in taxing federal obligations in 1983 and 1984 account for this change in result. The Michigan Bankers Association believes these figures demonstrate that financial institutions are not paying a reduced share of taxes in Michigan. The Michigan Bankers Association also contends that the passage of this tax will increase bank costs, reduce loan availability, and reduce bank profits in an already weak Michigan business climate.

2. Increase in the Intangibles Tax

The Tax Plan proposes a permanent increase in bank and savings and loan association intangibles. Unlike the temporary tax proposed in SB 341 (HB 4700), this tax change would not have a termination date. House Democrats view the intangible assets of financial institutions as fertile ground for increasing tax revenues. The arguments in favor of this permanent increase are similar to those discussed for the temporary increase in the intangibles tax.

The Michigan Bankers Association opposes taxing away profits of Michigan financial institutions. Michigan banks are ranked fourth worst in the

nation on the basis of after tax returns on capital.[14] Senate Republicans and the Michigan Bankers Association also fear the increase in bank costs and reduction in loan availability which this bill would cause.

C. Insurance Companies

1. Premiums Tax on Michigan Insurance Companies

House Democrats feel that insurance companies do not pay their fair share of Michigan taxes. 1983 statistics indicate that eleven of the largest insurance companies paid no tax at all.[15] After the U.S. Supreme Court decision in Metropolitan Life (see text, p11), Michigan's dual tax scheme for in-state and out-of-state insurance companies may be judicially held to be invalid. If they are held invalid, the disparity between taxes paid by insurance companies and taxes paid by other businesses will be increased. House Democrats feel that this bill should be passed to reduce the disparity in taxation.

House Republicans disagree that the Metropolitan Life decision clearly indicates that the current Michigan tax scheme for insurance companies is invalid. The Republicans emphasize that the Metropolitan Life case was remanded to determine if the intent of the differential tax scheme in Alabama would invalidate the tax. If the intent was based on more than just promoting in-state insurance companies or encouraging in-state investment, then the tax scheme could be valid. Metropolitan Life.

2. Health Insurance Contracts

Michigan Department of Treasury data suggests that Administrative Services Only (ASO) contract premiums are being taxed at a rate of less than 2%. House Democrats desire to tax all premiums at a minimum of 2%. The Governor's tax plan would make ineffective PA 189 and subject ASO premiums to the 2% Premiums Tax.

Federal law may not allow a state to tax ASOs. If valid under federal law, this tax would increase health care costs. The entire 2% tax could be simply passed on to consumers of health services. Senate Republicans believe the tax is inequitable because it would not affect any ASO contracts serviced by Blue Cross/Blue Shield.

D. Other Provisions

1. Computer Software Tax

The Michigan Merchants Council, representing various corporate chain stores in Michigan, supports the proposed tax on computer software, and was involved in drafting this bill. The Council feels that the description of software subject to taxation is crucial. House Democrats and the Council agree that computer software for general consumption, like home video games, should be taxed. A majority of other states now tax computer software, but Michigan does not. Macabees at 666. The Michigan State Chamber of Commerce supports this tax to the extent that only retail sales of canned computer software are taxed.

Senate Republicans feel that Michigan should encourage the growth of high technology business sectors. They believe a tax on this product is detrimental to Michigan's employment and business climate.

2. Tax Amnesty

The success of this type of plan in twelve other states has generated support in Michigan. Most House Democrats and Senate Republicans are in favor of the bills. They believe that if it is passes, the State will gain nearly $50 million.

Critics of the bill argue that individuals who did not pay taxes should not be rewarded. Repeated use of an amnesty policy could result in more tax avoiders seeking to reap the benefit of an amnesty program.

3. SBT Credits to Telephone Companies

House Democrats believe this credit should be eliminated. They note that the credit was implemented while Michigan was changing from a corporate tax to a value-added tax, and that similar credits applicable to other industries have been repealed.

The Michigan Telephone companies and the Michigan State Chamber of Commerce oppose this portion of the Governor's tax plan. They believe that an increase in state tax due to the elimination of a tax credit will pass the costs on to consumers. Greater taxes on a segment of industry will not improve the economic climate in Michigan.

## IV. CONCLUSION

Governor Blanchard's tax plan is comprehensive and controversial: it proposes changes in the taxation of personal income, capital gains, lump sum distributions, financial institutions, insurance companies and more; and it has divided the Michigan legislature and interest groups along traditional lines. House Democrats favor the shift in the tax burden which the Tax Plan would cause and have voted to enact the proposal. The Michigan Department of Treasury, interested in maintaining the State's recently balanced budget, is also a staunch supporter of the Tax Plan.

Senate Republicans and the Michigan Chamber of Commerce generally oppose the plan; and for equally predictable reasons. They fear the Tax Plan discourages business activity. They feel it inequitably distributes the tax burden upon businesses, and will cause venture capital to flow away from Michigan, creating long term economic development concerns.

## NOTES

1. House and Senate bills referred to in this article are all from the Michigan 83rd Legislature, Regular Session, 1985.

2. See IRC § 1211, IRC § 1202 and MCL 206.30; MSA 7.557 (130).

3. See IRC § 1202.

4. See MCL 205.132; MSA 7.556(2).

5. As of March 1986, the effective date of a rollback in the Michigan personal income tax rate is being debated and is likely to be compromised.

6. 1975 PA 288; MCL 208.1 to MCL 208.145; MSA 7.558 (1) to MSA 7.558 (145).

7. SB 343, p3; (HB 4702, p3); SB 344, p3 (HB 4703, p3).

8. SB 343, p4; (HB 4702, p4): SB 345, p2 (HB 4704, p2).

9. SB 349, pp.3-4; (HB 4708, pp3-4); SB 350, p5; (HB 4709, p5).

10. House Legislative Analysis Section, Governor's Tax Reform Package (6/17/85), p3.

11. See footnote 5.

12. Senate Republican Report on the Governor's Tax Plan, p20.

13. Senate Republican Report on the Governor's Tax Plan, p20.

14. Senate Republican Report on the Governor's Tax Plan, p25.

15. House Legislative Analysis Section, Governor's Tax Reform Package (6/17/85), p3.

# STATE TAXATION OF S CORPORATIONS

By: Janice M. Radlick

## I. INTRODUCTION

Since its inception in 1985, subchapter S of the Internal Revenue Code has allowed qualifying small business corporations to enjoy the limited liability and transferability of shares provided by a corporate form, but escape a tax at the corporate level. Michigan's repeal of the statute recognizing subchapter S status[1] resulted in confusion at the appellate court level over the correct state tax treatment[2] of S corporation income. In Chocola v Department of Treasury, the Michigan Supreme Court resolved the issue, holding that S corporation distributions, like distributions from a limited partnership, are business income, apportionable to the states where earned. With the Chocola ruling, the Supreme Court has adapted a policy consistent with the provisions of the Michigan Single Business Tax and the purpose of subchapter S. The following discussion will examine the state tax treatment of S corporation distributions proposed by the two panels of the Court of Appeals, and will outline the correct state tax treatment of S corporations, as mandated by the Michigan Supreme Court and the Department of Treasury.

## II. DEFINITION OF AN S CORPORATION

The Internal Revenue Code defines an S corporation as "a small business corporation for which an election under § 1362(a) is in effect for [the taxable] year." IRC § 1361(a). IRC § 1361(b) requires that an electing corporation be a domestic corporation with one class of stock[3] and 35 or fewer shareholders,[4] none of whom is a resident alien or an individual, estate, or trust. In addition, an S corporation cannot be a member of a parent-subsidiary group under IRC § 1505[5], a bank or other non-profit financial institution without capital stock, a corporation eligible for an IRC § 936 election, a D.I.S.C. or former D.I.S.C., or an insurance company taxed under subchapter L. IRC § 1361(b). If any of the requirements are breached, the election is automatically terminated. IRC § 1362(d)(2).

The Senate originally designed the subchapter S provisions to allow taxation of certain corporations under the rules of partnerships.[6] Instead, Congress enacted new provisions that tax qualifying corporations only in certain instances. Congress intended the new subchapter S option to mitigate the tax consequences of choosing a business organization. Neal v US, 313 F Supp 393 (CD Cal, 1970); 100 Cong Rec 571 (1954); 1954 US Code Cong & Admin News.

To elect subchapter S status, a qualifying corporation must file Form 2553 with the Internal Revenue Service Center where the corporation files its annual return. The corporation must elect subchapter S status during the previous taxable year or during the first 75 days of the taxable year, and all shareholders must sign the election. IRC § 1362(b) and IRC § 1372(a). A subchapter S election remains in effect until the corporation terminates it.

A successful S corporation election makes the corporation and its shareholders one entity for tax purposes. Like a partnership, an S corporation usually pays no federal income taxes. IRC § 1363(a). Income and losses pass through to the shareholders, who pay taxes on undistributed as well as distributed earnings. S corporations are taxed on capital gains which exceed $25,000 and on distributions of appreciated property to shareholders, to prevent corporations from electing subchapter S status solely to avoid taxation of such transactions. IRC § 1375. An S corporation is also subject to a tax on its "excess net passive income", if the corporation has accumulated earnings and profits from the years when the subchapter S election was not in effect, and its passive investment income exceeds 25% of its gross receipts. IRC § 1375(a).

Despite the different taxation provisions, the Internal Revenue Code in many instances prescribes identical treatment of S corporations and partnerships. For example, IRC § 1372 provides that S corporations shall be treated as partnerships for fringe benefit purposes. Similarly, the partnership rules for attribution of stock ownership and for income outside the United States apply to S corporations. IRC § 318(a)(5)(E) and IRC § 1373. Like a partnership, an S corporation must file an information return (Form 1120-S). IRC § 6037; Treas Reg § 1.6037-1(a).[7]

The subchapter S Revision Act of 1982, PL 97-354, altered the code to make S corporations and partnerships even more similar. For example, under the 1982 Act, the corporation's income, losses, deductions and credits retain their characterization as they pass through to shareholders. IRC § 1366. Thus, a shareholder's pro rata share of these items is treated as though realized from the same source, or in the same manner, as the corporation. Even tax-free income to the corporation is tax-free to the shareholder. The new law also allows an S corporation to maintain its status after an inadvertant act or omission that otherwise would terminate it. IRC § 1362(f). Thus, the S corporation form can be as advantageous and stable as a partnership.

## III. STATE TAXATION OF S CORPORATIONS

Although Michigan no longer recognizes subchapter S taxation[8], taxpayers base their Michigan taxable income (before adjustments) on their federal adjusted gross income. MCLA 206.30(1); MSA 7.557 (130)(1). Since a taxpayer includes S corporation income in federal adjusted gross income, his or her pro-rata share of S corporation income is included in the state tax base. The S corporation income is not subject to an additional tax.

### A. Michigan Taxation of Out-of-State S Corporations before Chocola

Until the Michigan Supreme Court decision in Chocola v Department of Treasury, 422 Mich 229; 369 NW2d 843 (1985), two conflicting decisions governed the proper treatment of out-of-state S corporation distributions. In Wilson v Department of Treasury, 122 Mich App 711; 333 NW2d 3 (1982), the Michigan Court of Appeals held that income from out-of-state S corporations was dividend income to Michigan residents, entirely includable in Michigan taxable income, while net operating losses from such corporations were "deductions in a trade or business", deductible only in the state where the trade or business occurred. Under MCLA

206.113; MSA 7.557 (1112), dividends are allocable to Michigan if the taxpayer "is a resident partnership, estate or trust or individual of this state or has a commercial domicile in this state." The Wilson court rejected the taxpayers' argument that out-of-state S corporation distributions were business income, taxed proportionately to the amount earned in Michigan, according to the formula in MCLA 206.115; MSA 7.557 (1115)[9]. The Wilson court cited IRC § 1373(b)[10] which stated that a taxpayer's pro rata share of S corporation income "shall be treated as a dividend." The court also cited IRC § 1374(b), which requires taxpayers to deduct S corporation net operating losses from gross income. Further, the Wilson court maintained that S corporation distributions could not be business income, arising "in the regular course of the taxpayer's trade or business", since the taxpayers were the shareholders, but the corporation carried on the business.

In Chocola v Department of Treasury, 132 Mich App 820; 348 NW2d 290 (1984) aff'd 422 Mich 229; 369 NW2d 843 (1985), a different panel of the Court of Appeals held that out-of-state S corporation income was business income subject to the apportionment formula. MCLA 206.4(2); MSA 7.557(104)(2) defines business income as "income arising from transactions, activities and sources in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, rental, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." Business income attributable to another state is an exception to the MCLA 206.110; MSA 7.557(110) requirement that all taxable income, from any source, is allocable to Michigan. Since the term "business income" includes gains and losses, Grunewald v Department of Treasury, 104 Mich App 601; 305 NW2d 269 (1981), this statement would also allocate net operating losses between states.

The Chocola court noted that S corporation income could not be a dividend, because it included undistributed income, but was analogous to partnership income. Partnership income is also taxed whether it is distributed or a mere "paper profit". Out-of-state partnership income and losses are business income, subject to apportionment. Grunewald v Department of Treasury, 104 Mich App 601; 305 NW2d 269 (1981), lv den 412 Mich 875 (1981). Because of the similarity between subchapter S income and partnership income, the Chocola court held that they were equivalent for tax purposes. The Court of Appeals also cited Department of Treasury regulations, 1979 AC, R 206.12(17)-(20), effective April 5, 1978, that required taxpayers to apportion subchapter S income to Michigan.

Under common law, an S corporation and its shareholders are separate entities and S corporation shareholders are not partners. Wilhelm v US, 257 F Supp 16 (Wyo 1966); US v Mid-West Business Forms, Inc., 474 F2d 722 (CA 8 1973). The Chocola court's treatment of S corporation income as business income, equivalent to that of a partnership, is justifiable, however, because Michigan does not recognize subchapter S status.

Because of the split between the Michigan Court of Appeals panels, the Michigan Supreme Court granted leave to appeal the Chocola decision, Chocola v Department of Treasury, 419 Mich 868 (1985).[12] The Supreme Court affirmed the Chocola court's treatment of S corporation income.

B. Chocola: The Michigan Supreme Court Decision

Chocola v Department of Treasury and Roberts v Department of Treasury,[13] the two cases consolidated for appeal by the Michigan Supreme Court, Chocola v Department of Treasury, 422 Mich 229; 369 NW2d 843 (1985), involved Michigan residents who owned stock in out of state S corporations (Indiana and Idaho, respectively) that did not do business in Michigan. The Michigan Supreme Court refused to adopt the Department of Treasury's view that S corporation distributions were dividends, the view held by the Court of Appeals in Wilson. The Michigan Supreme Court cited MCLA 206.11; MSA 7.557 (1110) which requires that inclusion of Michigan residents' dividend income in their Michigan tax bases "to the extent that they constitute a nonbusiness income." The Supreme Court affirmed the Court of Appeals' holding that the taxpayers' S corporation distributions were income from a trade or business, in the form of a dividend, but not dividend income under MCLA 206.100; MSA 7.557 (1110) and not entirely includable in the Michigan tax base. The Supreme Court also affirmed the interpretation by the Court of Appeals that the definition of "business income" in MCLA 206.4(2); MSA 7.557 (104)(2) did not require the taxpayers (i.e., the shareholders) to carry on the business, rather than the corporation, since S corporation shareholders, like partners, are participants in the corporation's business rather than "mere passive investor(s)." The court mentioned several factors demonstrating the active role of shareholders, including the limit on the number of shareholders (IRC § 1361(b)), the limit on S corporation passive investment income, the taxability of undistributed income (IRC § 1375(2)), and the character retention of income and loss items passed through to shareholders (IRC § 1366).

Further, the Chocola court noted that the Department of Treasury twice had made the argument that S corporation income was "business income." In Craighead v Department of Treasury, Mich Tax Rep (CCH), Paragraph 200-751 (1978), the department had argued that a Colorado S corporation's losses were allocable to Michigan, and not entirely deductible from the taxpayers' (Michigan residents) Michigan tax base. Similarly, in Hassebrock v Department of Treasury Mich Tax Rep (CCH), Paragraph 200-757 (1978), the department had maintained that a non-resident's Michigan S corporation distributions were allocable to Michigan. In both Craighead and Hassebrock, the Board of Tax Appeals ruled against the Department of Treasury, and held that S corporation distributions were dividend income allocable only to the state where the taxpayer resided.

Finally, the Chocola court stated that the rules[14] promulgated by the Department of Treasury (noted by the Court of Appeals in Chocola) controlled the treatment of S corporation income and required apportionment. Chocola at 240-241.

The addition of the characterization of income provisions in the Subchapter S Revision Act of 1982 also justifies the treatment of out-of-state S corporation income as business income. In Crook v Commissioner, 80 TC 27 (1982), the United States Tax Court held that S corporation income was includable in a shareholder's investment income, for purposes of computing the investment interest deduction. The Tax Court rejected the Commissioner's argument that the business character of the corporation's income passed through to the shareholder since the Internal Revenue Code (as it existed during the taxable years under consideration) did not provide for the pass through of the characterization of the corporation's

income. In a footnote, the Tax Court noted that under the pass through provisions of IRC § 1366, enacted by the Subchapter S Revision Act of 1982, S corporation income "presumably" would not qualify as IRC § 163 investment income.

C. Taxation of S Corporations by Other States

On a related issue, the Chocola court affirmed the Court of Appeals in Chocola and the Tax Tribunal in Roberts that MCLA 106.255; MSA 7.557 (1255) allows a credit for S corporation income which is taxed in another state in addition to Michigan. For example, another state might tax all of the S corporation income, while Michigan taxes that part attributable to Michigan. The tax credit prevents this double taxation.

MCLA 206.255; MSA 7.557 (1255) allows a resident a credit against the tax

> otherwise due under this act for the amount of an income tax imposed on a resident . . . for the taxable year by another state of the United States or a political subdivision of another state of the United States, the District of Columbia, or a Canadian province, or income derived from sources without this state which is also subject to tax under this act.

The Chocola court refuted the department's argument that S corporation income was not earned from a source outside of Michigan, (the department argued that the stock, not the corporation, was the source of income) on the grounds that S corporation earnings were income from a trade or business (i.e., "business income"). The Chocola court stated further that the statute did not require Michigan to recognize the taxing jurisdiction of the other state; it required only that a tax be levied.

D. The Department of Treasury's Response to Chocola

The Michigan Department of Treasury issued a tax bulletin (Income Tax Bulletin 1985-2) on October 1, 1985, noting the Chocola decision as mandating that taxpayers follow Administrative Rule 12,[15] in accord with the Supreme Court's decision. The bulletin outlined the treatment of S corporation income, and concluded that shareholders in an S corporation which confined its business activity to Michigan must pay taxes on the entire income, while shareholders in an S corporation which conducted business in other states must allocate that portion attributable to Michigan, and subtract the remainder from their Michigan tax bases. Likewise, subchapter S losses are subject to the apportionment formula, and S corporation shareholders with losses not attributable to Michigan must add back the non-attributable losses to calculate their Michigan tax base.

Further, the bulletin mandated that non-residents with income from a Michigan S corporation file Michigan tax returns, and all other S corporation shareholders file amended returns, form MI-1040X, to report income and losses allocable to Michigan. The Department of Treasury agreed to waive a penalty on any additional tax required if the taxpayer paid the tax and interest by

December 31, 1985. Otherwise, a four year statute of limitations applies. Michigan Tax Reports, Paragraph 201-187 Income Tax Bulletin 1985-2.

The Department of Treasury Bulletin also noted that the Chocola decision did not affect the Intangibles Tax imposed on a shareholder's investment in an S corporation. The Intangibles Tax, MCLA 205.121 et seq; MSA 7.555 et seq, taxes intangible personal property measured by the yield or value of the property. In Satterlund v Department of Treasury, MTT Docket Nos 61426-61248, September 10, 1982, the Michigan Tax Tribunal held that S corporation distributions qualified as "income" under the intangibles tax, and did not double tax the distributions, since the intangibles tax had a different purpose (to tax property) than the single business tax and the income tax. The Treasury Bulletin reiterated that the department would continue to tax the distributive income of an S corporation as yield under the Intangibles Tax.

## IV. CONCLUSION

Federal tax laws support the Michigan Supreme Court's decision to classify S corporation income as "business income" rather than dividends. S corporation distributions are not eligible for the partial dividend exclusion (IRC 166) and are not considered dividends for the IRC § 37 retirement income credit. Treas Reg 1.1375-2. Further, Congress's purpose in passing the subchapter S legislation (to avoid tax considerations in choosing a business entity), and the 1982 subchapter S amendments, which made the S corporation even more similar to a partnership, argue for taxation of S corporation income in the same manner as partnerships. Finally, The Multistate Tax Compact,[16] the purpose of which is to promote uniformity or compatibility between taxing states, "facilitate taxpayer convenience and compliance," and prevent duplicative taxation, mandates an interpretation of an interstate tax that equitably apportions the amount of tax payable to Michigan. Thus, the Chocola decision to apportion S corporation income using a formula which measures the payroll, the sales, and the property of the taxpayer applicable to Michigan, is a reasonable interpretation of the Single Business Tax and is the logical choice to encourage accurate reporting by taxpayers.

## NOTES

1. State Tax Guide, (CCH) at 1047; Chocola v Department of Treasury, 422 Mich 229, 240 n5 (1985). Michigan's former Income Tax Act, 1967 PA 281 § 81, repealed by 1975 PA 233 § 2, recognized subchapter S status.

2. See Wilson v Department of Treasury, 122 Mich App 711; 333 NW2d 3 (1982) and Chocola v Department of Treasury, 132 Mich App 820; 348 NW2d 290 (1980).

3. S corporations are limited to one class of stock to eliminate the inherent problems of distributing losses and profits among preferred and non-preferred, voting and non-voting stock. Barners Motor & Parts Company v U.S., 309 F Supp 298 (NC 1970); Parker Oil v Commissioner, 58 TC 985 A (1962).

4. Spouses are treated as a single shareholder. IRC § 1361(c).

5. S corporation status is determined without regard to the IRC § 1504(b) expectations.

6. 1954 U.S. Code Cong & Admin News, 5096-5100.

7. Filing this return commences the running of the statute of limitations for corporate tax deficiency assessments. IRC § 6037; Treas Reg § 1.6037-1(a).

8. See footnote, 1, supra.

9. Business income is apportioned by multiplying the income by the sum of the property factor plus the payroll factor plus the sales factor and dividing by 3. The property factor is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period divided by the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period. MCLA 206.116; MSA 7.557 (1116). The payroll factor is the total amount of compensation paid by the taxpayer in this state during the tax period, divided by the total compensation paid elsewhere. MCLA 206.119; MSA 7.557 (1119). The sales factor is the total sales of the taxpayer in this state during the tax period, divided by the total sales of the taxpayer everywhere during the tax period. MCLA 206.121; MSA 7.557 (1121).

10. The provisions cited by the Wilson court are now contained in IRC § 1368(c)(2).

11. MCLA 206.103; MSA 7.557 (1103) states that "any taxpayer having income from business activity which is taxable both within and without this state, other than the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this act." MCLA 206.105; MSA 7.557 (1105), states further that a taxpayer is taxable within and without Michigan if "(a) in that state he is subject to a net income tax, a

franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not."

12. The Supreme Court directed the parties to brief two issues: (1) Whether Michigan residents must pay income tax on their share of distributable income from an Indiana S corporation and (2) Whether Michigan residents may claim a credit against Michigan income tax for taxes paid to the State of Indiana on the same distributable income. Chocola v Department of Treasury, 419 Mich 868 (1985).

13. The Michigan Supreme Court granted leave to appeal in Roberts v Department of Treasury before consideration by the Court of Appeals, and ordered the parties to argue and submit the case with Chocola. Chocola v Department of Treasury, 422 Mich 229, 234.

14. 1979 AC R 206.12 states: (17) All distributive income from a subchapter S corporation includable in the shareholder's adjusted gross income is subject to tax if allocated or apportioned to Michigan. (20) Distributive income from a subchapter S corporation not allocated or apportioned to Michigan may be claimed as a subtraction from adjusted gross income. Conversely, losses not allocated or apportioned to Michigan shall be added to adjusted gross income.

15. See footnote 12 for text.

16. MCLA 205.581; MSA 7.555

## CORPORATE OFFICER - PERSONAL TAX LIABILITY

A corporate officer may be held personally liable for the corporation's unpaid taxes; and on an appeal regarding personal liability may not attack the amount of the assessment.

GMC Truck Center, Inc. v Michigan Department of Treasury, MTT Docket No. 74377, (September 6, 1985)

**FACTS:** Petitioner, an officer of Metro GMC Truck Center, Inc., appeals the assessment of a sales tax made due upon the basis of corporate officer liability. Metro GMC was assessed with sales tax on March 1, 1982. Two weeks later the corporate books were seized pursuant to bankruptcy proceedings. The sales tax was not paid or appealed by the corporation within the statutory allotted time. On January 24, 1983, petitioner received a personal tax assessment for the corporation's unpaid taxes. This assessment was based on petitioner's derivative liability as a corporate officer.

Respondent argues that petitioner is liable for the taxes of the corporation under MCLA 205.65; MSA 7.537. Pursuant to the statute, respondent contends that: 1) Petitioner is liable for the unpaid taxes because he was a corporate officer responsible for making the sales tax returns and payments; and 2) Petitioner may not contest the amount of the tax assessed since the corporation did not appeal the amount of the tax within the statutory time limits.

Petitioner argues that: 1) He should not be liable as a corporate officer since he was only involved in the truck sales, and was not responsible for making the sales tax payments; and 2) He may attack the accuracy of the sales tax assessment. Petitioner claims that he received his first notice of this liability on January 24, 1983, in the form of a final assessment against himself personally. He argues that it was impossible for him to contest the amount of the assessment because the corporate books were seized after the assessment against the corporation was issued. As a result, he contends that the notice to the corporation was defective, and that, therefore, he should be allowed to attack the amount of the assessment.

**HELD:** The amount of the assessment is affirmed and petitioner is personally liable for the taxes. Firstly, a corporate officer may be held personally liable for unpaid corporate sales tax if the officer had control of, had supervision of, and was responsible for making the corporate sales tax return. The evidence shows that petitioner was intimately involved in the day to day operation and finances of the business. Therefore, he is liable for the sales tax as a responsible officer of the debtor corporation.

Secondly, petitioner may not attack the amount of the assessment; he may only attack his liability as a corporate officer. In Michigan, an unappealed final assessment becomes due and payable by operation of law. The assessment against Metro GMC was not appealed by the corporation within the statutory time and thus became final. When payment was not forthcoming, respondent lawfully sought payment from petitioner based on his derivative liability as a corporate officer in

charge of making the sales tax returns. Petitioner's claim that notice to the corporation was defective fails. The notice to the corporation was issued on March 1, 1982, nearly two weeks before the seizure of the records. As an officer of the corporation petitioner should have known about the assessment. If he did not become aware of the assessment, it was due to a communication failure within the corporation, and not due to a defective notice. In civil matters, due process requires that the manner of notice be reasonably calculated to inform the appropriate persons. It does not require that individuals actually receive notice. MCLA 205.65; MSA 7.537 gives an officer of a corporation a single chance to appeal the amount of the tax assessment against the corporation; and limits any appeal by the officer regarding personal liability to the issue of whether they possessed the control necessary for personal liability.

## CORPORATE TAX RECORDS - EXAMINATIONS

The Revenue Commissioner or the duly appointed agents of the Commissioner may employ the assistance of individuals related to the investigation to aid in the examination of a taxpayer's tax records.

Michigan Department of Treasury v Psychological Resources, Inc., Docket No. 76860, ___ Mich App ___; ___ NW 2d ___ (October 11, 1985)

**FACTS:** Defendant Psychological Resources, Inc. appeals from an order of the Oakland County Circuit Court which compelled defendant to produce certain corporate tax records for examination pursuant to MCLA 205.3(a); MSA 7.657(3)(a). Defendant objects to plaintiff's use of defendant's former bookkeeper, Gladys Johnson, as an assistant to its treasury agents in their examination of defendant's records.

Johnson was employed as a bookkeeper by defendant from April 1979 to July 1980. Plaintiff prosecuted Johnson for embezzlement and she was convicted. Subsequently, Johnson was charged with tax evasion to which she pleaded guilty. Plaintiff states that the investigation of defendant was motivated by Johnson's allegations that the books and records of defendant would lead to proof of tax fraud by defendant.

Defendant argues that the lower court's order was erroneous because Johnson is not authorized by statute to assist plaintiff in its examination of defendant's records. MCLA 205.3(a); MSA 7.657, states in part:

> The commissioner or any of the duly appointed agents . . . may examine the books . . . touching the matter at issue . . .

Defendant contends that since Johnson is not the commissioner or a duly appointed agent, she may not assist in the examination of its records.

**HELD:** Affirmed. The circuit court's order allowing the defendant's former bookkeeper to assist the plaintiff in examination of defendant's records did not violate MCLA 205.3(a); MSA 7.657(3)(a). The operative word in the statute is "examine". The language states clearly that Johnson can not examine defendant's records if she is not the commissioner or a duly appointed agent of the commissioner. Yet the statute does not prohibit Johnson from aiding the agents in their examination. Johnson was not ordered by the court to examine the records, but only to aid those who did have authority to examine them. The commissioner or the duly appointed agents may use information from persons involved in the matter being investigated to aid in their examination.

## GENERAL SALES AND USE TAX ACT - EXEMPTIONS

The exemption from the Use Tax Act for replacement of body parts does not apply unless the taxpayer makes a sale to the ultimate consumer; and the industrial processing exemption does not apply unless there is, at some time, a sale at retail of the completed product.

Thomas Terchek, III d/b/a Howell Dental Lab v Michigan Department of Treasury, MTT Docket No. 90393, (October 29, 1985)

**FACTS:** Petitioner seeks to set aside a Use Tax assessment for 1979 through 1983. Petitioner produces and repairs dental appliances upon written order from dentists. Petitioner contends that he is engaged in selling tangible personal property, and is therefore entitled to the exemption covering the sale of body replacement parts by prescription. Rule 61 of the General Sales and Use Tax Rules and Regulations, R205.111, and Rule 89, R.205.139. Respondent argues that petitioner's business activities are those of a supplier and do not constitute retail sales to the ultimate consumer.

**HELD:** Affirmed. Petitioner is not entitled to the replacement parts exemption. This exemption applies only to the purchase by the ultimate consumer, and petitioner does not make sales to the ultimate consumer. Further, petitioner is eligible for the industrial processing exemption. This exemption requires that there must, at some time, be a subsequent sale at retail of the completed product. Petitioner performs a service for a dentist, who, in turn, performs a service for his patients. There is no subsequent sale at retail.

## GOVERNMENTAL IMMUNITY: INTENTIONAL TORTS

The Department of Social Services (DSS) is immune from suit for damages arising out of intentional tort of DSS employees; yet the individual employees may be subject to suit.

Julia Justice v State of Michigan and the Department of Social Services, 145 Mich App 352; 377 NW 2d 417 (September 3, 1985)

**FACTS:** Petitioner appeals from a summary judgment which dismissed her action on the grounds of governmental immunity. Petitioner, who received Aid to Dependent Children (ADC) benefits, purchased a home subject to a mortgage. The amount of the monthly mortgage payment made petitioner eligible for a monthly excess shelter allowance. The respondent failed to pay petitioner the excess shelter allowance and, as a result, petitioner defaulted and foreclosure proceedings began.

At a subsequent administrative hearing, it was found that petitioner had been wrongfully denied the excess shelter allowance, and respondent was ordered to reimburse petitioner for back excess shelter allowances and to assist petitioner in redeeming the foreclosed mortgage. The respondent failed to comply with the order and the house was lost at the expiration of the redemption period. Petitioner brought suit in the Court of Claims for damages sustained by the loss of her home. Respondent moved for accelerated judgment on the grounds that the Court of Claims lacked subject-matter jurisdiction because petitioner was seeking review of the administrative order. The court granted respondent's motion and petitioner appealed. The Court of Appeals reversed, holding that the Court of Claims had jurisdiction since the nature of the claim was one for damages for tortious conduct. On remand, respondent moved for summary judgment on the grounds of governmental immunity. The Court of Claims granted respondent's motion and petitioner appealed.

**HELD:** Affirmed. The respondent is immune from suit under MCL 691.1407; MSA 3.996(107). This statute provides tort immunity to all government agencies engaged in the exercise of a government function. The administering of a social welfare program, like ADC, is clearly a government function for which the defense of governmental immunity exists.

Petitioner should have brought suit against the individual employees. An action against the individual employees would have survived on the grounds of their negligent failure to comply with the order, or alternatively, on the grounds that the employees acted outside the scope of their authority in refusing to comply with the order. However, petitioner did not name these individual employees in her complaint, and has not pleaded facts which would establish that the employees committed an ultra vires act.

**OVERPAID TAXES - INTEREST REFUND CLAUSE**

Unlawfully paid sums bear interest from the date payment is received, not the date full payment is received. MCLA 205.737(4); MSA 7.650(4).

Copco Steel & Engineering v City of Detroit, MTT Docket No. 57151 (October 29, 1975)

**FACTS:** Petitioner paid school and local taxes on its property in Detroit in 1981 and 1982. Pursuant to Detroit City Code Section 8-403(3), petitioner paid half its taxes for both years before August 15 and January 15 of each year. No interest is collected on the taxes if paid by this method. Petitioner appealed to the Tax Tribunal in June 1981, contesting the assessment of its property. Subsequently, petitioner and respondent reached an agreement on the amount of taxes assessed for 1981 and 1982.

On December 2, 1983, the Tax Tribunal entered a Partial Consent Judgment which established a true cash value assessment consistent with the agreement between petitioner and respondent. Respondent adjusted its tax rolls in accordance with the judgment and remitted petitioner's excess payments.

The dispute arose over respondent's computation of the interest on this excess amount. Respondent calculated the interest at a rate of 1% per month from the date full payment was received. Petitioner filed a Motion for Clarification of Interest. MCLA 205.737(4); MSA 7.650(37)(4) governs the award of interest from the Tax Tribunal. It provides that "any sum . . . unlawfully paid shall bear interest from the date of payment to the date of judgment and the judgment shall bear interest to the date of its payment." Petitioner contends that each installment payment was a separate property tax payment, and that, therefore, any amount exceeding one-half the total assessment, plus interest, was to be refunded from the date of each installment payment.

Respondent argues that MCLA 205.737(4); MSA 7.650(37)(4) states that the date of payment is the date the full tax payment is received. Respondent also maintains that a home rule city, like Detroit, has the authority to create procedures inconsistent with the General Tax Act, and that the definition of payment contained in Detroit City Code section 18-19-13 should apply.

**HELD:** Petitioner's Motion for Clarification of Interest granted. Any unlawful sums paid bear interest from the date of payment. In order to receive interest, only the fact of payment is essential; the taxes need not be fully paid. Respondent must recompute petitioner's refund, pursuant to the December 2, 1983 Partial Consent Judgment. Petitioner's refund must be offset by the amount respondent has already paid petitioner. Pursuant to Detroit City Code section 8-403(3), petitioner may pay its property taxes in two installments. The reduction in petitioner's property tax assessments for 1981 and 1982 indicates that petitioner paid more than was necessary. MCLA 205.737(4); MSA 7.650(37)(4) requires that petitioner receive interest on the excess sum from the date of actual payment to the date of refund.

Respondent's argument that the Detroit City Code's definition of payment applies because Detroit is a home rule city is rejected. The provisions of the Tax Tribunal Act are effective notwithstanding provisions to the contrary in any statute, charter, or law.