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BILL



ANALYSIS

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House Bill 5937 (as reported without amendment)  
Sponsor: Representative Andrew Kandrevas  
House Committee: Tax Policy  
Senate Committee: Finance

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### **RATIONALE**

Although the Single Business Tax (SBT) Act was repealed several years ago, issues still arise with respect to liability under the Act. One of these concerns the treatment of business entities that have a single owner. Under Federal regulations that govern the classification of taxpayers, an eligible single-owner entity may choose to be either recognized as a taxpayer separate from its owner, or disregarded as a separate entity. In 1999, the Michigan Department of Treasury issued a Revenue Administrative Bulletin (RAB) to explain the application of the Federal regulations to the SBT and individual income tax (RAB 1999-9). The RAB required a taxpayer to file its SBT return on the same basis as its Federal classification and stated, "If a single member unincorporated entity is disregarded as an entity separate from its owner (a tax nothing) at the federal level, it is treated as a branch, division, or sole proprietorship for SBT purposes." In May 2009, however, the Michigan Court of Appeals held that a taxpayer that elected to be classified as a disregarded entity for Federal tax purposes nevertheless could file a return separate from its owner under the SBT Act (*Kmart Michigan Property Services v Michigan Department of Treasury*, described below).

In response to this decision, on February 5, 2010, the Department of Treasury issued a Notice to Taxpayers *requiring* entities to file a separate SBT return if they are disregarded for Federal tax purposes and filed as a division of their owner for SBT purposes. The Notice states that previously disregarded taxpayers are considered

nonfilers for purposes of the statute of limitations, and returns must be filed for all tax years for which the entities exceed the SBT filing threshold. The Notice also requires businesses to file amended returns if they previously filed returns that included disregarded entities.

It has been pointed out that there are thousands of disregarded entities in existence, and each of these taxpayers will have to file a return for every prior year in which it filed as a division of its owner. Each of the owners also must file amended returns. This may result in an overall tax reduction in some cases, while additional taxes will be due in others. The primary concern among taxpayers, however, appears to be the administrative burden imposed by preparing new or amended returns for many years. It has been suggested that legislation should be enacted to address this situation.

### **CONTENT**

**The bill would amend the revenue Act to give direction to the Department of Treasury regarding the treatment of a taxpayer that filed a Single Business Tax return that included an entity disregarded for Federal income tax purposes, and the treatment of the disregarded entity.**

Specifically, for a taxpayer that filed a tax return under the former Single Business Tax Act that included an entity disregarded for Federal income tax purposes under the

Internal Revenue Code, both of the following would apply:

- The Department of Treasury could not assess the taxpayer an additional tax or reduce an overpayment because the taxpayer included the disregarded entity on its SBT return.
- The Department could not require the disregarded entity to file a separate tax return.

In addition, if a taxpayer filed an SBT return that included an entity disregarded for Federal income tax purposes, the taxpayer could not claim a refund based on the disregarded entity's filing a separate return as a distinct taxpayer.

The bill states the following: "This amendatory act is curative, shall be retroactively applied, and is intended to correct any misinterpretation concerning the treatment of an entity disregarded for federal income tax purposes under the internal revenue code under... [the former SBT Act] that may have been caused by the decision of the Michigan court of appeals in Kmart Michigan Property Services v Michigan Department of Treasury, No. 282058, May 12, 2009. However, this amendatory act is not intended to affect a refund resulting from a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted prior to February 12, 2010 to a taxpayer who is a party to that proceeding."

MCL 205.27a

## **BACKGROUND**

*Kmart Michigan Property Services v Michigan Department of Treasury* (283 Mich App 647) addressed the tax treatment of Kmart Michigan Property Services (KMPS), which was a limited liability company wholly owned by Kmart Corporation. The Michigan Court of Appeals held that KMPS was entitled to file a separate Single Business Tax return even though it had elected to be disregarded as an entity separate from its owner for Federal tax purposes.

The issue arose after the Department of Treasury audited KMPS in connection with an audit of Kmart Corporation. The Department determined that KMPS should not have filed a separate SBT return, but

should have submitted its income, deductions, credits, assets, and liabilities with those of Kmart for the tax year at issue. KMPS would have been entitled to a refund for the tax year if the Department had allowed it to file a separate SBT return. A referee determined that KMPS was not entitled to a refund, and the company appealed to the State Tax Tribunal.

KMPS argued that it met the definition of "person" under the SBT Act (which required every person with business activity in the State to pay the SBT), and therefore qualified to file a separate return. The Department argued that KMPS had to file its SBT return as a disregarded entity, since it was a single-member limited liability company—in which case KMPS's income would have been attributed to its owner, and Kmart would have been responsible for paying all taxes due. The Tax Tribunal concluded that a limited liability company fit within the statutory definition of "person" whether it had one or more members.

The Department then contended that the decision of KMPS to be a disregarded entity for Federal tax purposes overrode its legal status as a person for State tax purposes. Federal Treasury regulations, called "check-the-box", set forth the classification of organizations for Federal tax purposes. The regulations state, "A business entity that is not classified as a corporation...can elect its classification for federal tax purposes... An eligible entity...with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." The regulations also contain a default rule under which an eligible entity that does not make an election is considered disregarded. As allowed by these regulations, KMPS had elected to be a disregarded entity for Federal tax purposes, instead of being recognized as a separate entity.

To support its position, the Department relied on the requirement in Revenue Administrative Bulletin 1999-9 that a taxpayer file its SBT return on the same basis as its election for Federal taxation. The RAB also stated, "[I]f a single member entity is disregarded for federal income tax purposes, its activities are included as part of the owner's activities...". The Tax Tribunal noted, however, that the RAB did not have the force of a legal requirement.

The Court of Appeals agreed that KMPS was not legally required to follow the RAB and stated, "Neither the SBTA [Single Business Tax Act] nor federal regulations require an entity to be consistent in its self-classification with respect to its state and federal tax filings for a given year...[T]he SBTA does not support the requirement of RAB 1999-9 that an organization that is a disregarded entity for federal tax purposes for a given taxable period must also file as a disregarded entity for state tax purposes."

On September 28, 2009, the Michigan Supreme Court denied leave to appeal.

## **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

### **Supporting Argument**

For a number of years, Michigan businesses complied with Department of Treasury policies set forth in RAB 1999-9. Unincorporated single-owner businesses that were disregarded entities for Federal tax purposes also were disregarded for purposes of the SBT Act, and were included in the SBT returns of their owners. The Court of Appeals in the Kmart case, however, held that such an entity qualifies as a "person" under the SBT Act, even if it elected to be disregarded for Federal tax purposes or was considered disregarded because it did not make an election. The Department therefore issued its Notice to Taxpayers requiring all disregarded entities to file separate SBT returns retroactively for each year in which they were treated as a division of their owner. At the same time, all of the businesses that filed SBT returns that included disregarded entities must file amended returns.

In addition, the Notice to Taxpayers states that interest is due for any deficiencies in tax payments and will be added to the tax from the time it was originally due. The filing deadline is September 10, 2010, and penalties will be assessed against any previously disregarded entity that fails to file by that date.

These requirements are unfair for several reasons. Taxpayers that relied on the Department's policies for many years now face the tremendous task of filing new or

amended returns for all "open periods". Since the Department considers previously disregarded entities to be nonfilers, returns must be filed for *all* tax years for which the entities exceed the SBT filing threshold. For some taxpayers, this look-back period will be as long as 10 or 20 years. If the affected taxpayers have a tax liability, they will be charged interest for the entire time the tax was due. On the other hand, if taxpayers' liability is reduced, refunds will be paid only for the four years prescribed by the Act.

The bill would remedy this situation with a statutory amendment. It would eliminate the filing requirement both for disregarded entities and for businesses whose returns included disregarded entities. It also would bar the Department from assessing a tax, interest, or penalty as a result of the Kmart decision. These provisions would relieve taxpayers of both the burden of filing new or amended returns, and cost of additional SBT liability and interest. At the same time, the bill would protect the State, by preventing taxpayers from claiming a refund as a result of the decision. In effect, the tax treatment of the affected entities would be restored to the status quo that existed before the Kmart decision.

Legislative Analyst: Suzanne Lowe

## **FISCAL IMPACT**

The bill would have an indeterminate effect on State revenue and no effect on local revenue or expenditure. Any impact on State revenue would affect the General Fund. Entities that were previously excluded could either exhibit liabilities or be due refunds. The impact of the bill would depend on the net impact of the additional returns that would be received absent the bill.

Fiscal Analyst: David Zin

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.