# *Treatment of Single Member LLCs Under SBT and MBT after the* Kmart *and* Alliance *Decisions*

By Donald A. DeLong

## Introduction

Prior to the 2009 Michigan Court of Appeals' decisions in *Kmart Michigan Prop Servs, LLC v Department of Treasury*[1] and *Alliance Obstetrics & Gynecology, PLC v Department of Treasury,*[2] most taxpayers and practitioners believed that a single member limited liability company's (SMLLC) election under the federal "check-the-box" regulations was determinative of how that SMLLC would be treated under Michigan's now repealed Single Business Tax Act (SBTA).[3] It now appears that an SMLLC may choose to be treated differently under the Internal Revenue Code and the SBTA, and possibly the Michigan Business Tax Act (MBTA).[4] This change will impact not only choice of entity decisions, but other tax decisions regarding the elections that SMLLCs will make under the federal and Michigan tax statutes.

## Federal and State Tax Law Background

### *Treatment of SMLLCs under the Check-the-Box-Regulations*

The tax classification of SMLLCs under the Internal Revenue Code is determined under the check-the-box regulations.[5] For the purposes of this article, an SMLLC is an entity organized under the Michigan Limited Liability Company Act[6] (MLLCA) that has only one member or owner. The check-the-box regulations make clear that "…whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law."[7] Therefore, for federal tax purposes the exact nature of how the SMLLC is organized under Michigan law is not determinative of how it will be treated under the Internal Revenue Code.

A business entity that has a single owner can choose to be classified as a corporation or as a disregarded entity for federal tax purposes.[8] If the business entity is treated as a disregarded entity, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[9] In other words, the fact that an SMLLC is a separate legal entity under Michigan law is not relevant under the Internal Revenue Code; the activities of the SMLLC will be treated as those of its owner, and it will not file a separate income tax return from its sole owner.

The SMLLC may elect to be treated as a corporation under the Internal Revenue Code, and if it does, it is treated as an association with activities separate from those of its owner and must file separate returns from those of its owner. If an SMLLC does not make an election to be treated as a corporation, it will be treated as a disregarding entity under the default rules.[10]

### *Treatment of SMLLCs Under the SBTA*

Under the SBTA, a tax was imposed on every "person" with business activity in Michigan.[11] "Person" was defined as "an individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit."[12] A limited liability company is not enumerated in the types of entities defined as a "person," nor did the statute state how an SMLLC is to be treated under the SBTA. On November 29, 1999, the Michigan Department of Treasury (MDT) issued Revenue Administrative Bulletin (RAB) 1999-9, which attempted to state that SMLLCs would be classified the same under the SBTA as under the Internal Revenue Code and the check-the-box regulations. In RAB 1999-9, the MDT stated that any such election or default classification under the check-the-box regulations was effective "for all components of the SBT return that are related to federal income tax" and "[a] taxpayer who elects entity classification at the federal level shall file the Michigan SBT return on the same basis and reflect the same tax consequences." [13] This RAB specifi-

cally states that if an SMLLC is treated as a disregarded entity "…at the federal level it is treated as a branch, division, or sole proprietor for SBT purposes."[14] Therefore, under this RAB, an SMLLC would be classified in the same manner under the SBTA as under the check-the-box regulations.

### *Kmart and Alliance Court of Appeals Decisions*

The Court of Appeals in *Kmart* held that Kmart Michigan Property Services, LLC (KMPS) was not required to be consistent in its self-classification in its Michigan and federal tax filings for any given year.[15] KMPS was a Michigan limited liability company wholly owned by Kmart Corporation. KMPS filed a separate single business tax return from its sole member, Kmart Corporation, even though KMPS was treated as a disregarded entity for federal tax purposes. The MDT determined that it would not accept the separate return of KMPS and, instead, would disregard this entity and treat it as if it were a division of Kmart Corporation.

The MDT relied on RAB 1999-9 in arguing that KMPS was required to use the same entity classification that it had chosen for federal tax purposes with respect to its filings under the SBTA. The Court of Appeals found that while RAB 1999-9 was entitled to respectful consideration, it was not legally binding.[16] Since this Revenue Administrative Bulletin was not legally binding, the Court looked to the language of the SBTA to determine whether KMPS was required to file an SBT return. The Michigan Court of Appeals determined that KMPS did fit within the definition of a "person" conducting business activity within the state of Michigan.[17] According to the SBTA, all persons conducting business activity within the state were required to file an SBT return. The Court concluded that KMPS was correct in filing an SBT return even though it did not file a separate federal income tax return since it was a disregarded entity under the check-the-box regulations.

The *Kmart* decision was released on May 12, 2009. On August 4, 2009 the Michigan Court of Appeals revisited this issue in the *Alliance* decision. The Court in *Alliance* came to the same conclusion as the Court did in its *Kmart* decision under a different set of facts. In *Kmart* the taxpayer was a disregarded entity under the federal check-the-box regulations, whereas in *Alliance* the taxpayer elected to be treated as a corporation.

In *Alliance*, the plaintiff, Alliance Obstetrics & Gynecology, PLC was a limited liability company with a single member. The plaintiff had made an election under the check-the-box regulations to be treated as a corporation for federal income tax purposes. Accordingly, the plaintiff filed a separate single business tax return and claimed a small business credit under MCL 208.36. The MDT disallowed the small business credit because, under MCL 208.36(2)(b)(i), a corporation whose officers earned more than $115,000 during the tax year was not entitled to the small business credit. Since the plaintiff had elected to be treated as a corporation for federal income tax purposes, the MDT determined that this was a binding classification for all purposes under the SBTA, including the calculation of the small business credit.[18]

The Michigan Court of Appeals in *Alliance* cited its decision in *Kmart* for the proposition that classifications under the federal and state statutes were not binding on one another.[19] The Court stated that limited liability companies are not corporations under Michigan law and that "[b]usiness entities such as plaintiff that are neither a corporation nor a partnership should not be required to elect a classification inconsistent with its organization under state law."[20] The Court in *Alliance* held that the plaintiff was not to be treated as a corporation for purposes of calculating the small business tax credit under MCL 208.36(2), and, thus, it was entitled to take the credit.[21]

### *Response to Kmart Decision by MDT and Michigan Legislature*

On February 5, 2010, the MDT issued a notice to taxpayers regarding the impact of the *Kmart* case. The MDT stated "pursuant to Kmart, persons that are disregarded entities for federal tax purposes that filed as a branch, division, or sole proprietor of their owner for SBT purposes ('previously disregarded entities') must now file a separate SBT return for all open tax periods. Previously disregarded entities are considered non-filers for statute of limitation purposes under MCL 205.27a."[22] The MDT stated that SMLLCs were required to file or amend their returns for all open tax years under rules laid out by the *Kmart* decision and the February 2010 Notice. All these returns were due on or before September 30, 2010. Returns not filed on or before September 30, 2010 would have interest assessed for any deficiencies, which interest would

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be added to the deficiency from the time the tax was originally due. Interest on refunds would be calculated and added to the refund commencing 45 days after the claim is filed.[23] The MDT would assess a penalty against any previously disregarded entities that did not file a return by September 30, 2010.[24] Moreover, the MDT stated that previously disregarded entities would be considered non-filers for statute of limitations purposes.[25] This meant that SMLLCs would have to go back and file tax returns for all years in which their revenues exceeded the filing threshold. However, SMLLCs that previously filed SBT returns that included one or more previously disregarded entities had to amend their returns for all open years, but they could not amend their SBT returns beyond the statute of limitations set forth in MCL 205.27a. The February 2010 Notice was going to be a tremendous administrative burden on both SMLLCs and the MDT.

The Michigan Legislature, recognizing this burden and the inherent unfairness of the MDT's position in its February 2010 Notice, introduced House Bill 5937.

The Michigan Legislature, recognizing this burden and the inherent unfairness of the MDT's position in its February 2010 Notice, introduced House Bill 5937. In March 2010, this bill was reported out of committee. The committee report described the situation as follows:

> 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.[26]

House Bill 5937 was passed by the Michigan Legislature and signed by the Governor on March 31, 2010 as 2010 Public Act 38 (PA 38). PA 38 became effective on March 31, 2010. PA 38 amended section 207a of 1941 Public Act 122, as amended by 2003 Public Act 23, being MCL 205.27a. In pertinent part, PA 38 amends MCL 205.27a by adding the following language:

> (8) Notwithstanding any other provision in this act, for a taxpayer that filed a tax return under former 1975 PA 228 [the SBTA] that included in the tax return an entity disregarded for federal income tax purposes under the internal revenue code, both of the following shall apply:
>
> (a) The department shall not assess the taxpayer an additional tax or reduce an overpayment because the taxpayer included an entity disregarded for federal income tax purposes on its tax return filed under former 1975 PA 228.
>
> (b) The department shall not require the entity disregarded for federal income tax purposes on the taxpayer's tax return filed under former 1975 PA 228 to file a separate tax return.
>
> (9) Notwithstanding any other provision in this act, if a taxpayer filed a tax return under former 1975 PA 228 that included in the tax return an entity disregarded for federal income tax purposes under the internal revenue code, then the taxpayer shall not claim a refund based on the entity disregarded for federal income tax purposes under the internal revenue code filing a separate return as a distinct taxpayer.[27]

It is important to analyze what PA 38 does and what it does not do. First, PA 38 does not amend the SBTA to change the definition of "person" and, in fact, does not amend the SBTA at all. Second, PA 38 makes no mention of the MBT and should not have any impact on the interpretation of this tax act. Third, PA 38 does not approve nor disapprove of the analysis or holdings of *Kmart* and does not even mention the *Alliance* decision. PA 38 does state in its enacting section 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 former 1975 PA 228 that may have been caused by the decision of the Michigan court of appeals in *Kmart*….[28]

If the above enacting language is read in light of MCL 205.27a(8), it does not appear that PA 38 is disapproving the analysis of *Kmart*, but just "correcting any misinterpretation" regarding the treatment of SMLLCs "that may have been caused" by the *Kmart* decision. What PA 38 does do is reflected in the actual language of MCL 205.27a(8). PA 38 changes the requirements for filing returns under the SBTA that were made mandatory by the February 2010 Notice. Under PA 38, if the owner of an SMLLC filed a return treating the SMLLC as a disregarded entity then (1) the MDT cannot increase or decrease that owner's tax liability because the owner did not file a separate return for the SMLLC, and (2) the owner cannot be required to file a separate return. PA 38 also states that the owner cannot file a separate SBT return for the SMLLC if it originally filed its return treating the SMLLC as a disregarded entity. Significantly, PA 38 does not mention anything about owners of SMLLCs that may have filed separate returns even though they may have elected to be treated as disregarded entities under the federal check-the-box regulations. Reading the language of the committee report, PA 38, and its enacting language together, it appears that PA 38 actually "repeals" the MDT's February 2010 Notice because it, in essence, does away with this Notice's SBT filing requirements, without addressing the analysis of *Kmart*.

On April 12, 2010 the MDT issued a "new" Notice rescinding its previous February 2010 Notice.[29] The April 2010 Notice says that "2010 PA 38 reinstates the law governing disregarded entities under the SBT in effect prior to *Kmart*."[30] It also goes on to say that the February 2010 Notice is rescinded and concludes "that RAB 1999-9 and RAB 2000-5 reflect the correct interpretation of the law regarding the treatment of disregarded entities under the SBT."[31] It appears that the MDT in its April 2010 Notice interprets PA 38 as doing away with the analysis of *Kmart* altogether, which as pointed out above does not appear to be the case.

The *Kmart* decision made two important determinations. First, that RABs, while entitled to respect, were not binding on the Court's interpretation of the SBTA and by extension any Michigan tax act. Second, *Kmart* interpreted "person," as defined in the SBTA, to mean SMLLCs and that the check-the-box regulations did not affect that definition, thus requiring SMLLCs to file separate returns. PA 38 does away with the requirement of filing separate returns, but not the analysis of *Kmart* as described above.

## Impact Under the SBTA

PA 38 and the *Kmart* and *Alliance* decisions affect SMLLCs and their treatment under the SBTA in several ways. While *Kmart*'s interpretation of "person" is not changed, PA 38 does not allow SMLLCs to file separate returns if they have elected to be treated as disregarded entities under the check-the-box regulations, but SMLLCs that have already filed separate returns should not have to amend their returns because PA 38 does not require this, and the February 2010 Notice has been rescinded. Those SMLLCs who did file separate returns may be subject to audit challenge by the MDT because of its interpretation in its April 2010 Notice.

SMLLCs that elected to be treated as corporations and that took the small business credit under MCL 208.36 should still be able to take the small business credit under the analysis of the Michigan Court of Appeals in *Alliance*. This means that an SMLLC that paid in excess of $115,000 to a member is not disqualified from taking the small business credit because the member is not considered an officer or shareholder of the SMLLC. SMLLCs that did not take the small business credit on any open year returns because of "compensation" to a member in excess of $115,000 might consider filing an amended return and seeking a refund.

The impact on SMLLCs under the SBTA is admittedly limited due to its repeal effective December 31, 2007. Only SMLLCs who have open years or who are subject to audit will be able to rely on *Kmart* and *Alliance*.

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## Impact Under the MBTA

### *Filing a Separate Return If an Election Is Made To Be Treated As a Disregarded Entity Under the Check-the-Box Regulations*

The MBTA has two different types of taxes. The MBTA imposes a modified gross receipts tax (GRT) on taxpayers with Michigan nexus at the rate of 0.8 percent.[32] It also levies the business income tax (BIT) on taxpayers with Michigan business activity at the rate of 4.95 percent.[33] The term "taxpayer" is defined as "a person or a unitary business group liable for a tax, interest, or penalty under this act…."[34] A person is

defined in MCL 208.1113(3) as including a limited liability company. As a result, except for a unitary business group, which will be discussed later, an SMLLC is a person subject to the MBT, just as *Kmart* decided under the SBT.

The approach that the MDT will take on this issue can be gleaned from the Frequently Asked Questions (FAQs) issued by the MDT since the passage of the MBTA. Specifically, FAQs Mi25 and Mi28 reveal that the MDT will follow RAB 1999-9. Mi 25 asks "Does the MBT follow the federal check-the-box regulations?" with answers that can be summarized as follows: (1) Yes, the MBT follows the federal regulations; (2) for single-member disregarded entities, the single member is an MBT taxpayer and the SMLLC will be treated as a sole proprietorship, branch, or division; and (3) an SMLLC will only be a MBT taxpayer if it elects to be taxed as a corporation for federal tax purposes *and* is not part of a unitary group.[35]

FAQ Mi 28, in pertinent part, asks: "Are single member limited liability companies…disregarded for federal tax purposes also disregarded under the MBT?"[36] The answer to this question is that the MBT generally conforms to the check-the-box regulations and SMLLCs will be treated as sole proprietorships, branches, or divisions of the sole members. Both FAQs Mi25 and Mi28 were issued on April 15, 2008 before the *Kmart* and *Alliance* decisions. In light of April 2010 Notice, they are not likely to be rescinded. Therefore, SMLLCs that are not part of a unitary business group could argue that they can file as a corporation or a disregarded entity regardless of how they file under the check-the-box regulations. SMLLCs that are not part of a unitary business group will for the most part be SMLLCs whose sole members are individuals or foreign entities, not United States entities such as corporations, partnerships or limited partnerships, or limited liability companies. These types of SMLLCs should make an independent analysis of the tax impact on them from a federal income tax and MBT standpoint taking into consideration the likelihood of challenge from the MDT if audited.

SMLLCs whose sole members are entities must take into consideration the unitary business group rules. A unitary business group must:

> file a combined return that includes each United States person, other than a foreign operating entity, that is included in the unitary business group. Each United States person included in a unitary business group or included in a combined return shall be treated as a single person and all transactions between those persons included in the unitary business group shall be eliminated from the business income tax base, modified gross receipts tax base, and the apportionment formula under this act.[37]

Unitary business group is defined, in pertinent part, as:

> a group of United States persons, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.[38]

A full discussion of the unitary business group concept is beyond the scope of this article, but an SMLLC whose sole member is an entity organized in the United States will be part of a unitary business group and will be required to include its business activities as part of its sole member's tax return. In short, SMLLCs with members that are United States entities will not be able to file separate returns under the analysis of *Kmart* because of the unitary business group rules.[39]

Some SMLLCs might consider organizing their parent entities as a foreign corporation in light of the unitary business group rules to avoid having to file a single consolidated return. If the tax benefits are substantial, some taxpayers may consider organizing the sole member of the Michigan SMLLC as a foreign entity, but only if the foreign entity is an "operating" entity.

### *The Small Business Tax Credit*

The MBT, like the SBT, has a small business tax credit.[40] A taxpayer that qualifies for the small business tax credit effectively reduces its MBT liability (combination of GRT, BIT, and surcharge) to 1.8 percent its adjusted business income. To qualify for the credit, a taxpayer must not exceed $20 million of gross receipts and $1.3 million (adjusted for inflation after 2008) of adjusted business income.[41] As under the SBT, the MBT disqualifies entities whose owners have compensation over certain thresholds. As applied to SMLCCs, if its sole member receives more than $180,000 as a distributive share of the SMLLC's adjusted business income (minus the loss adjustment), the SMLCC is disqualified from using this credit. In addition, a corporation is disqualified from taking this credit if the compensation and director's fees of a shareholder or an officer exceed $180,000.

In *Alliance*, the SMLLC (i.e., the plaintiff) elected to be taxed as a corporation under the check-the-box regulations, but claimed the small business credit despite its sole member receiving in excess of $115,000 from the SMLLC. The court in *Alliance* pointed out that the term "corporation" was not defined in the SBTA. Since the SMLLC in *Alliance* was not a corporation under Michigan law, it was not a corporation for purposes of the SBTA and the small business credit.

The MBT, however, does define the term "corporation" as "a taxpayer that is required or has elected to file as a corporation under the internal revenue code."[42] Based on this definition, an SMLLC that elects to be treated as a corporation under the check-the-box regulations will fall within the definition of a corporation for the purposes of MBT, including the small business credit under the MBT. Accordingly, an SMLLC in the same situation as the plaintiff in *Alliance* will not be able to make that same argument and will be disqualified from using this credit.

## Conclusion

The decisions in *Kmart* and *Alliance* have a significant impact on SMLLCs that have open tax years to which the SBT applies. Despite the MDT's April 2010 notice that PA 38 has "repealed" the *Kmart* decision, it appears that the analysis of this decision is still viable. Therefore, affected SMLLCs might consider filing returns or amended returns that classify the SMLLCs differently than under the check-the-box regulations. Practitioners should consider doing an analysis of savings that might be achieved. The impact of the *Kmart* and *Alliance* decision on the MBT's treatment of SMLLCs is less dramatic. Many SMLLCs that might have considered filing separate returns under the SBT will probably not be able to do so under the MBT as a result of the unified business group rules. However, SMLLCs that do not fall within the unitary business group rules might consider taking the position that they are not bound by the check-the-box regulations in connection with their classification under the MBT since it appears that the rationale of the *Kmart* and *Alliance* decisions are still valid, notwithstanding the MDT's position. This might present a planning opportunity for SMLLCs. However, any SMLLC that takes this position should only do so with the knowledge that the MDT will probably not agree with this analysis.

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**NOTES**

1. 283 Mich App 647, 770 NW2d 915 (2009).
2. 285 Mich App 284, 776 NW2d 160 (2009).
3. MCL 208.1 et seq., which was repealed by 2006 PA 325 effective December 31, 2007.
4. MCL 208.1101, et seq., which became effective January 1, 2008.
5. Treas Reg 301.7701-1 (the check-the-box regulations).
6. MCL 450.4101 et seq.
7. Treas Reg 301.7701-1(a)(1).
8. Treas Reg 301.7701-2(a).
9. *Id.*
10. Treas Reg 301-7701-3(b)(ii).
11. MCL 208.31(1).
12. MCL 208.6(1).
13. RAB 1999-9 at 2.
14. *Id.*
15. *Kmart*, 283 Mich App at 654.
16. *Id.*
17. *Id.*
18. *Alliance*, 285 Mich App at 286.
19. *Id.*
20. *Id.*
21. *Id.*
22. "Notice to Taxpayers Regarding Kmart Michigan Property Services LLC v. Dept of Treasury, The Single Business Tax, RAB 1999-9, and RAB 2000-5" (February 5, 2010) (the February 2010 Notice), which can be found at http://www.michcpa.org/Content/Public/Documents/Direct%20File%20Links/Kmart%20Notice%20Retroactive%20Application%20Amended%20Returns.pdf.
23. *Id.*
24. *Id.*
25. *Id.*
26. "Disregarded Entity: SBT Returns H.B. 5937: Analysis As Reported From Committee" (March 25, 2010).
27. MCL 207.27a(8).

28. MCL 207.27a, enacting section 1.

29. "Rescinded: Notice to Taxpayers Regarding *Kmart Michigan Property Services LLC V Dep't Of Treasury*, The Single Business Tax, RAB 1999-9, and RAB 2000-5" (April 12, 2010) (hereinafter referred to as the April 2010 Notice), which can be found at: http://www.michigan.gov/documents/taxes/Kmart_Notice_Retroactive_Application_Amended_Returns_1_310402_7.pdf.

30. *Id*.

31. *Id*.

32. MCL 208.1203.

33. MCL 208.1201.

34. MCL 208.117(5).

35. Michigan Business Tax Frequently Asked Questions, page 82 (April 15, 2008), which can be found at http://www.michigan.gov/documents/taxes/MBTFAQ_208917_7.pdf.

36. *Id*. at page 84.

37. MCL 208.1511.

38. MCL 208.1117(6).

39. The unitary business group rules will also require more SMLLCs to file MBT returns since the filing threshold of $350,000 will more likely be reached when filing as part of a unitary business group than separately. SMLLCs, whether they elected to be treated as corporations or disregarded entities under the check-the-box regulations will become part of larger groups of entities under these rules and SMLLCs that were not subject to the SBT because of its threshold of $350,000 will now be subject to the MBT.

40. MCL 208.1417.

41. *Id*.

42. MCL 208.1107(3).

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