

Subject:
**Update on Calculating
Michigan Business Tax
Deferred Taxes**

State and Local Tax Alert

The Tax Practice at EHTC P.C. specializes in planning for income and franchise taxes; sales and use taxes; real and personal property taxes; business incentives; site selection, and tax credits; as well as cost segregation and depreciation. Our experienced state and local tax executives are dedicated to reducing your tax burden to the fullest extent possible.

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Summary

On December 1, 2007, Michigan Governor Jennifer Granholm signed into law Public Act 145, which repealed the use tax on services that had been enacted on October 1, 2007, and made many modifications to the Michigan Business Tax ("MBT"). The most significant change made to the calculation of the MBT was the imposition of a new "surcharge" on the business income and modified gross receipts taxes. The imposition of this surcharge **will impact** MBT taxpayers' deferred taxes in several ways, some of which could be detrimental for financial statement purposes. Taxpayers should be analyzing the impact of the imposition of the surcharge now, if they have not done so already.

Initial Deferred Tax Calculation: First Financial Reporting Period Including July 12, 2007

On July 12, 2007, the Governor signed Senate Bill 94, establishing the replacement tax for the repealed Michigan Single Business Tax ("SBT"), known as the "Michigan Business Tax" or "MBT." For FAS 109 purposes it is EHTC's position that both components of the MBT, the Business Income Tax ("BIT") and the Modified Gross Receipts Tax ("MGRT"), are income taxes. With the imposition of a new tax that is considered an income tax for FAS 109 purposes, deferred taxes must be calculated for the cumulative difference between book and tax basis for all items on the balance sheet that are considered in the calculation of the new tax. Additionally, the impact of the cumulative effect must be recorded at the end of the financial reporting period which includes the enactment date of the tax, July 12, 2007 for the MBT. For calendar year taxpayers that are publicly traded, the cumulative effect, if any, should have been recorded at the quarter ended September 30, 2007.

Calculating the New MBT Deferreds

For MBT taxpayers that previously did not consider the SBT an income tax, new deferred taxes were required to be recorded related to the new BIT (or existing deferred taxes would need to be adjusted if deferred taxes were recorded for SBT). For the BIT component of

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the MBT, the book-tax differences would typically be based on the same book-tax differences that taxpayers used for their federal and other state deferred income tax calculations.

All MBT taxpayers should have calculated the deferred tax liability associated with the MGRT. Even though the MBT did not go into effect until January 1, 2008, certain assets on the balance sheet prior to then would have been allowed as a deduction as a “purchase from other firms” when acquired, if the tax would have been in effect. Since a tax deduction theoretically would have been allowed in the past and will not be allowed in any future period, there is no MGRT tax basis for these assets. The timing difference in the deduction is caused by the fact that the “purchases from other firms” deduction is fully taken at the time of acquisition of the assets, in contrast to the method of accounting that most taxpayers are on for book and tax purposes (i.e. some sort of capitalization methodology). Since the MGRT basis for each of these assets is zero (i.e. the asset is fully expensed at the time of acquisition) and the net book value for these assets is likely positive (e.g. unsold inventory or fixed assets that have not been fully depreciated for book purposes), there cannot be a deferred tax asset associated with the MGRT, only a deferred tax liability.

The rates to be used in the above calculations are ones that were provided in the original MBT legislation, as those were the ones in effect for the first financial reporting period ended after July 12, 2007. Those rates were 4.95% for BIT and 0.8% for MGRT. While many taxpayers will have significant book-tax basis differences (especially for the MGRT), it is important to note that a taxpayer’s Michigan apportionment percentage will be the best indicator of how significant the financial statement impact will be from the imposition of the new MBT.

Financial Statement Relief

On September 30, 2007, House Bill 5104 was enacted, which provided relief for taxpayers that would have had to record a net deferred tax liability on their financial statements as a result of the enactment of the BIT and MGRT portions of the new MBT. The deduction was intended to create a deferred tax asset which would offset any net deferred tax liability of a taxpayer which would have resulted from the enactment of the BIT and MGRT.¹ This legislation creates a deduction “out of thin air” that a taxpayer can use against its future BIT base, if the taxpayer had to record a net deferred tax liability due to the imposition of the MBT. Even though a taxpayer will not begin to take the deduction until 2015, taxpayers are allowed to record the associated deferred tax asset without any reduction for time value of money considerations.²

Due to this relief provision, many taxpayers chose not to complete detailed calculations to determine the appropriate deferred taxes associated with the imposition of the new MBT. Taxpayers assumed that there should be no material detrimental impact to their financial statements as a result of this relief provision. It is still unclear as to which date a taxpayer should use to “measure” its net deferred tax liabilities for purposes of establishing this deduction that will be taken in later years. Per the language of the statute, the deduction should be calculated for “the first fiscal period ended after July 12, 2007.” The term “first fiscal period” is not defined anywhere in the MBT Act and is not a term that is used within Generally Accepted Accounting Principles (GAAP). However, per MCL §208.1201(3), the deduction is calculated as “the amount necessary to offset the net deferred tax liability” which would result from the imposition of the BIT under section 201 and the MGRT under section 203. By allowing a deduction to offset the impact of reporting the cumulative deferred tax liabilities associated with the BIT and MGRT, this provision appears to be attempting to match up the date at which the deduction should be calculated with the date at which the net deferred tax liabilities are required to be recorded under GAAP. If this was the intended result then the first financial reporting date for a publicly traded company would be at the first quarter end that occurs after July 12, 2007 (e.g. September 30, 2007 for a calendar year company). Since it is unclear at which date the “measurement” should occur, the Michigan Department of Treasury may take the position that a taxpayer’s net deferred tax

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liability must be measured at a period end date that is closer to enactment (e.g. July 31, 2007). The Michigan Department of Treasury has not offered any guidance yet as to which measurement date a taxpayer must use.

Imposition of the Surcharge

On December 1, 2007, Public Act 145 was enacted and provides for the imposition of an annual surcharge on each MBT taxpayer's tax liability under the MBT Act after allocation and apportionment but before credits. For all persons, other than insurance companies and financial institutions, the rate is 21.99%. This effectively means that the rates previously enacted (4.95% and 0.8%) have now been increased to 6.039% (BIT) and 0.976% (MGRT), respectively.

There is a sunset clause for the surcharge which provides that, if certain economic conditions within Michigan are met, then the surcharge will not be imposed on or after January 1, 2017. As long as there is greater than zero personal income growth in Michigan for 2014, 2015, or 2016 over the previous year, then the surcharge will no longer be imposed after 2016. The contingency that will cause the surcharge to remain in effect after 2016 appears to be highly unlikely to occur if historical data is representative of what will occur in Michigan in the future. There has only been one period of time in the past (from 1930 through 1933) where Michigan experienced declines in personal income for three consecutive years. In addition, the last single year in which Michigan experienced a decline in personal income was in 1958 but in 1957 and 1959 Michigan experienced growth in personal income.

Updated Deferred Tax Calculation: First Financial Reporting Period Including December 1, 2007

Pursuant to FAS 109, the increase in the BIT and MGRT rates are required to be taken into consideration in valuing taxpayers' deferred taxes for the first financial reporting period ending/ended after December 1, 2007. For calendar year taxpayers, this will be the period ended December 31, 2007.

In general, the modifications to the previously calculated BIT and MGRT deferred taxes will simply be to update the book-tax differences and recalculate the expected future value of each deferred tax asset or liability, taking into account the surcharge. On its face it would appear that the recalculation of the deferred taxes to take into consideration the effect of the surcharge would be as simple as increasing the rate used in the calculation. This may not be correct in light of the sunset date/contingency contained within the surcharge provision. Since the surcharge will be eliminated unless a future contingent event occurs, it may not be proper to apply the effects of the surcharge to all of a taxpayer's deferred taxes across the board.

The criteria for the recognition of deferred taxes are covered under FIN 48: Accounting for Uncertainty in Income Taxes. Based on FIN 48, the term "tax position" can refer to "a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets." The standard for recording the benefit of a tax position is that it is more likely than not (MLTN) that the taxpayer would sustain the benefit. Based on this it would appear that a taxpayer would need to establish that it is MLTN that the surcharge will be in existence for a given deferred tax asset or liability to apply the effects of the surcharge. Given the current status of the MBT Act, it is MLTN that the surcharge will be in effect prior to January 1, 2017 but it does not appear to be MLTN that the surcharge will be in effect after December 31, 2016 because the existence of the surcharge after this date is contingent on a future event that, based on historical data, is highly unlikely to occur.

Pre-2017 vs. Post-2016 Book-Tax Differences

Since the surcharge will be eliminated after December 31, 2016 unless an unlikely contingent future event occurs this means that deferred tax balances should be calculated utilizing the surcharge for book-tax differences that are expected to reverse prior to 2017 and without the surcharge for book-tax differences that
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are expected to reverse after 2016. This approach is familiar to multi-national taxpayers who have been required to “schedule out” the expected reversal of book-tax differences to correctly account for the phase-in effect of a foreign country lowering its corporate income tax rates over several tax years (e.g. corporate rate reduction enacted in Canada). EHTC believes that this approach is the most theoretically sound approach to calculating a taxpayer’s MBT deferred taxes because the enactment of the surcharge statute is not contingent, instead the continued existence of an item (i.e. the surcharge) within the enacted statute is based on a contingent future event. No legislative action is required in the future for the surcharge to sunset. Based on this, EHTC believes that since the contingent event that must be satisfied to retain the surcharge is highly unlikely to occur a reader of the financial statements would not expect a company to record the effects of the surcharge for book-tax differences expected to reverse after 2016. Book-tax differences that taxpayers should analyze more carefully and possibly schedule out to determine how much will reverse after 2016 include such items as post retirement benefits, intangibles (if there is no known plan to write down the value or sell them prior to 2017), and buildings.

Please note that the above conclusion as to how to value deferred taxes in the post-2016 tax years is EHTC's position as to the most accurate way to report MBT deferred taxes for financial statement purposes, based on the guidance in FAS 109. However, some accountants may hold a different view of how to apply FAS 109. Some accountants may allow/require their clients to account for the surcharge impact on all deferred taxes irrespective of what year the underlying book-tax difference is expected to reverse. *Therefore, each company should make its own accounting policy decision with respect to how to account for the surcharge in the post-2016 tax years in conjunction with its accountants.* Although EHTC’s position is described above, we would consider this alternative view that the surcharge rate should be used in valuing all deferred taxes until the elimination of the surcharge is proven by personal income growth in 2014, 2015, or 2016 on a case-by-case basis dependent on the level of materiality of the surcharge effect. However, if a company utilizes the surcharge rate in valuing all of its deferred tax assets and liabilities irrespective of when the underlying book-tax difference is expected to reverse, it is important to note that the company might *experience material write-offs* of deferred tax balances on its 2014 financial statements for the surcharge effect that had been applied to book-tax differences that are expected to reverse after 2016 (i.e. in 2015 it is likely that the statistic will be available as to the personal income growth in 2014 and, if there is any growth, the surcharge will be eliminated after 2016 and thus the deferred taxes would have to be revalued without the effect of the surcharge).

Surcharge Impact on Future MBT Deduction

Taxpayers must also recalculate the expected tax benefit (i.e. the deferred tax asset) of the deduction provided for under the relief act because of the imposition of the surcharge. However, **only the deferred tax asset will change (i.e. the expected future tax value of the deduction), not the deduction amount itself.**

The Michigan Department of Treasury issued the following guidance on its website regarding the impact of the surcharge on its Frequently Asked Questions list:

B5. Is the deduction provided under MCL 208.1201(2)(i) altered by the MBT surcharge?

No. The deduction provided in section 201(2)(i) functions to offset the book-to-tax difference or deferred tax liability resulting from the change from the SBT to the MBT. The credit is taken in defined percentages beginning in tax year 2015. MCL 208.1201(2)(1).

MCL 208.1201(3) states that the deduction is only available in "the amount necessary to offset the net deferred tax liability" which would result under the business income tax under section 201 and the modified gross receipts tax under section 203. The amount of the deferred tax liability and the corresponding deduction will be calculated without reference to the surcharge, and the deduction will therefore remain the same as calculated prior to the enactment of 2007 PA 145.

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The Department recognizes that this is a significant issue for the business community creating a need for guidance upon which it can rely. While the business community may rely on this form of guidance, the Department also intends to issue a Revenue Administrative Bulletin in the near future that further explains the position described above.

Based on the response above, it appears that the BIT deduction, provided with House Bill 5104, was not expanded to cover any increased net deferred tax liabilities resulting from the imposition of the new surcharge. This means that the deduction amount should not be altered from the amount previously calculated at the measurement date which was at the first fiscal period ended after July 12, 2007. This deduction was what kept taxpayers from having any detrimental impact on their financial statements from the enactment of the MBT. However, with the imposition of the surcharge, any taxpayer in a net DTL position due to the enactment of the new MBT may now have a detrimental impact on its financial statements due to the combination of the higher rate (causing an increase in net DTLs) and the lack of relief for the impact of the higher rate (no corresponding increase in the deduction).

However, MCL §208.1201(3) does indicate that the amount of the deduction previously calculated, based on the enactment of the new BIT and MGRT, can reduce the surcharge imposed. This means that the deduction, allowed beginning in tax year 2015, can be taken against a taxpayer's business income tax base for purposes of calculating the applicable surcharge. As a result of this, the value (i.e. the deferred tax asset) of the deduction should be revalued under FIN 48 to take into consideration the actual future value it is estimated to have. However, it should be noted that the deduction is expected to only reduce the surcharge for two years (2015-2016) because it may be difficult for a taxpayer to establish that it is MLTN that the surcharge will be in effect after 2016 because of the contingent future event that must occur for the surcharge to remain in effect.

The deduction provided for under MCL §208.1201(2)(i) will be allowed in increments, and the amount allowed in 2015 and 2016 is 4% of the total deduction, per year (the remaining 92% of the deduction will be taken in 2017 through 2029). Therefore, in order to revalue the deferred tax asset associated with the deduction for the impact of the surcharge, taxpayers should use the higher BIT effective rate (6.039%) for only 8% of the deduction amount. Because of the fact that the majority of the originally recorded benefit (DTA) will be received in post-surcharge years, the value of the DTA will increase only slightly (only the portion related to 2015 and 2016) compared to the possible increase in the net DTL that it was originally offsetting (~100% of the net DTLs may increase due to the surcharge, assuming the taxpayer's net DTLs are expected to reverse prior to 2017).

Therefore, taxpayers that previously may have reported no impact to their financial statements as a result of the deduction created under the relief legislation might now have a financial statement impact due to the surcharge, for several reasons:

- Deferred tax liabilities/assets that are expected to reverse prior to 2017 should be calculated with the effects of the surcharge to ascertain the expected future tax outlays/benefits.
- Deferred tax liabilities/assets that are expected to reverse after 2016 should be calculated without the effects of the surcharge to ascertain the expected future tax outlays/benefits.
- The deferred tax asset related to the financial statement relief deduction should be recalculated utilizing the surcharge for 8% of the deduction and not utilizing the surcharge for the remaining 92% of the deduction.

Reporting Requirements for the Deferred Tax Relief Deduction

The original guidance regarding the deduction allowed under MCL §208.1201(3) stated: "the department may require the taxpayer to report the amount of this deduction on a form as prescribed by the department
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that is to be filed on or after the date that the first quarterly return and estimated payment are due under this act.” To date, there has been no additional guidance from the Department related to this potential reporting requirement.

How EHTC Can Help

The deferred tax implications of the new MBT have become even more complex with the imposition of the new surcharge. Taxpayers should review their calculations with the above guidance in mind and discuss their intended approach with their accountants to determine whether or not a more detailed calculation might be required. Additionally, the deduction amount that will be allowed in the future is expected to be a one time calculation, likely to be reported within the next few months, so taxpayers should document their calculations in detail now.

EHTC state tax professionals can assist your company in identifying the deferred taxes required to be recorded related to the MBT, including the surcharge. We can also assist your company in determining the process for calculating and documenting the future deduction allowed to offset much of the net deferred tax liability impact of the imposition of the new MBT. We are continuing to monitor the guidance provided by the Department and, as clarifications are provided, will communicate such updates.

¹ MCL §208.1201(3)

