

## IRC Section 318 and Parental Attribution for Purposes of the Michigan Business Tax Unitary Business Group Control Test

The purpose of this State and Local Tax Information email is to discuss attribution from children to parents for purposes of the Michigan Business Tax (MBT) Unitary Business Group (UBG) Control Test. A UBG must satisfy both the *Control Test* and one of two *Relationship Tests*. IRC Section 318(a)(1)(A)(ii) mandates that a parent or parents are deemed to own all stock or other ownership interest owned by the child or children of parents. This discussion raises three questions relevant to attribution from a child to a parent: Must the parent be living? Must the parent have been a shareholder? What if the siblings did not get along?

### Control Test

The control test is satisfied when one person owns or controls, directly or indirectly, more than 50% of the ownership interest with voting or comparable rights of the other person or persons. Control is generally determined using IRC Section 1563. Indirect ownership is generally determined using IRC Section 318 or analogous authority, except that the Department will apply both Section 1563 and Section 318 to all forms of ownership interests, such as partnership and membership interests, and not just corporate stock. [Treasury FAQ U33]

### Family Member Attribution

Section 318(a)(1)(A) provides that an individual is deemed to own stock owned (directly or indirectly) by his or her:

- spouse
- children
- grandchildren
- parents

### Attribution from Children

For purposes of Section 318(a)(1)(A)(ii), attribution of shares from children includes those held by legally adopted children. [Section 318(a)(1)(B)] For purposes of that Section, the term “lineal descendants” includes legally adopted children and grandchildren. Without legal adoption by the step-parent, there is no attribution of shares from step-children to a step-parent or to step-grandparents. In addition, without legal adoption of the child, there is no attribution from a step-parent to step-children.

## **No Attribution between Siblings**

There is no attribution of stock between siblings under Section 318(a)(1). Attribution of stock is limited to close family members. Moreover, aunts, uncles, nieces, nephews, and cousins are not within the purview of these attribution rules.

The Section 318 attribution rules aim to expand the concept of stock ownership in order to achieve the purposes of the numerous provisions for which they apply. This typically results in deemed ownership of all or a portion of the outstanding stock of a corporation by multiple related parties.

**IRC Section 318(a)(1)(A)(ii) mandates that a parent or parents are deemed to own all stock or other ownership interest owned by the child or children of parents.**

**EXAMPLE:** Jane Smith is the surviving spouse of John Smith. During their married life together, John Smith and Jane Smith had two children (John Jr. and Jim) who are now successful business owners.

John Smith was a successful businessman organizing and developing several firms that manufactured and sold construction equipment. Many years ago (1970s) he sold his business interest in the two entities to his sons. Since then, John Smith enjoyed many years of retirement living not involved in his prior business endeavors. John Smith died peacefully in 2002.

John Smith, Jr. owns (100%) of a construction equipment manufacturing company (Smith Manufacturing) which operates from facilities located in Belding, Michigan. All the property and payroll are located in Michigan and all sales are made to Smith Distributing.

Jim Smith owns (100%) of a multistate construction equipment distributorship (Smith Distributing) located in Greenville, Michigan. All the property and payroll are located in Michigan. Sales are made throughout the United States through a network of independent sales persons located outside of Michigan. Approximately 90% of the customers are located outside of Michigan.

Both Smith Manufacturing and Smith Distributing are very successful and profitable. Both companies paid a substantial amount of Single Business Tax (SBT) because of compensation in Michigan.

On a separate return basis Smith Manufacturing would pay about \$1 Million in MBT. Smith Distributing would pay on a separate return basis about \$200,000 in MBT because of apportionment. Smith Manufacturing cannot apportion MBT tax base.

If Smith Manufacturing and Smith Distributing filed a combined unitary MBT return, the MBT tax would be \$100,000. Eliminating all intercompany sales from both the Modified Gross Receipts Tax Base and in the apportionment formula resulted in significant savings. The accountant for Smith Manufacturing and Smith Distributing has recommended a unitary combined return be filed.

Could Treasury block the filing of a unitary combined return and require separate returns? The short answer is **NO**. However, the real answer might be **MAYBE**. Please read on.

**DISCUSSION:** Because of the sales between Smith Manufacturing and Smith Distributing, the two entities would satisfy the relationship test in that they are vertically integrated. Based on direct ownership, they would fail the control test because no one person owns or controls more than 50%. However, when the attribution rules of IRC Section 318(a)(1)(A)(ii) are applied, the mother is deemed to own all the stock owned by her two sons. Therefore, the Michigan Business Tax Act (MBTA) requirement in Section 117(6) [MCL 208.1117(6)] of one person owns or controls, directly or indirectly, more than 50% of the ownership interest is satisfied.

If Treasury were to block the filing of a combined unitary return, they would have to block the imposition of the attribution rules in IRC Section 318(a)(1)(A)(ii). They might be able to do this if they reached down into Federal case law relating to the attribution rules in IRC Section 318. Treasury stated in FAQ U34 that indirect ownership is generally determined using IRC 318 or analogous authority, except that the Department will apply IRC 318 to all forms of ownership interests, such as partnership and membership interests, and not just corporate stock. [Treasury FAQ U34]

What does the term “analogous authority” mean? Treasury has not defined “analogous authority.” It could be narrowly defined to include only relevant provisions of the Internal Revenue Code and the underlying Income Tax Regulations. Or, it could be broadly defined to include the Internal Revenue Code, Income Tax Regulations, Revenue Bulletins, Procedural Bulletins and all relevant case law. The latter would certainly add to the confusion; however, it might give Treasury a basis for blocking the filing of a combined unitary return in the above example.

### **Judicial Decisions**

**The following federal judicial decisions raise three questions: Must the parent be living? Must the parent have been a shareholder? What if the siblings did not get along?**

In *Garber Industries* [*Garber Industries Holding Co. Inc. v. Commissioner*, 124 T.C. No. 1, Doc 2005-1549, 2005 TNT 16-8 (2005)], the question was the availability of net operating loss carryovers. Garber Industries asserted that two separate corporations owned by two brothers was in fact one after application of the attribution rules in IRC Section 318. Neither of the parents or grandparents was alive during the years in question. They argued that the brothers were members of the same family. Therefore, the stock owned by the family group had not changed as a result of the sale from one brother to another. As support, it cited Section 382(l)(3)(A)(i), which provides that “an individual and all

members of his family described in paragraph (1) of Section 318(a) shall be treated as one individual for purposes of applying this Section.”

The IRS’s response was to point to the language of Section 318(a)(1)(A), defining members of a family as including (i) an individual’s “spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and (ii) his children, grandchildren, and parents.” That does not include “brothers and sisters,” the IRS said.

Garber Industries admitted that, at first glance, the IRS might appear to be correct. But closer analysis, the corporation suggested, would show that:

**“although siblings are not family members described in Section 318(a)(1), Charles and Kenneth are nonetheless members of the same family when such determination is made by reference to their parents and grandparents. That is, as sons, they are both members of each family consisting of a parent and that parent’s family members. . . . Accordingly,**

**. . . Charles and Kenneth are treated as one individual under Section 382(l)(3)(A)(i), with the result that transactions between them are disregarded for purposes of Section 382.”**

#### **Must the parent be living?**

Even if that analysis were valid, responded the IRS, it still would apply only with reference to living individuals. None of the Garber parents or grandparents had been alive at any time during the three-year testing period, so there was no living individual during that time whose family members could be treated as including both Charles and Kenneth.

#### **Must the parent have been a shareholder?**

Judge Halpern, in the Gerber Industries case, said neither interpretation made sense. Therefore he came up with a third approach that put the family group focus solely on individuals who are shareholders of the loss corporation:

Congress intended individuals to be aggregated with the same family members to whom their shares would otherwise be attributed under Section 318(a)(1), which in turn suggests that Congress intended the family aggregation rule to apply from the perspective of individuals who are shareholders of the loss corporation. . . . In other words, composite shareholders are to be constructed only around individuals who directly or indirectly (through an entity or by means of an option) own shares of the loss corporation.

Because neither the parents, nor the grandparents, of the two Garber brothers had ever been shareholders in Garber Industries, this scuttled the argument that Kenneth and Charles were members of one family group that owned most or all of the stock at all relevant times for Section 382 ownership

change purposes. Therefore, there was an ownership change and the IRS was correct in its calculation of the limited amount of the NOL available to the corporation in tax year 1998.

Looking at the issues in our example, John Smith was a shareholder in each of the two corporations. However, he is deceased. Jane Smith, the surviving spouse, is alive. However, she was never a shareholder. Could Treasury block the filing of a combined unitary return because neither parent was alive and a former shareholder? MAYBE Or, could the taxpayer assert that the mother who is alive was also indeed a former shareholder through attribution while her spouse was alive? MAYBE

### **What if the siblings did not get along?**

The idea of attribution, of course, is that the economic interests of some taxpayers are closely aligned with other taxpayers. For that reason, an individual is generally deemed to own the stock owned by a corporation of which he or she owns 50 percent or more of value and is deemed to own the stock owned by her or his partnership.

While members of the family are assumed to operate in the best interests of the family, the reality is that family discord is as old as the family itself. Thus, taxpayers have occasionally argued that the family attribution rules are a useful presumption, but that tax law deals with realities and an erroneous assumption can and should be rebuttable by strong evidence of family discord.

In *Metzger Trust* [*Metzger Trust v. Commissioner*, 693 F.2d 459 (5th Cir. 1982), 95 TNT 38-245] Circuit Court Judge Patrick E. Higginbotham introduced the opinion of the three-judge panel by saying:

We decide today a story driven by tensions as old as Genesis but told in the modern lexicon of the tax law. It is the story of David who built a business and left it in the charge of his eldest son Jacob to be shared with Jacob's two sisters Catherine and Cecelia, of their alienation and resulting quarrel with the tax collectors.

In *Metzger Trust*, the IRS did not dispute that there was discord, perhaps even hatred, between the siblings. The IRS said it was irrelevant. The only question was whether the statutory requirements of Section 302(c)(1) had been met so that the family attribution rules of Section 318(a)(1) could be waived. The IRS concluded that they had not.

*Metzger Trust* argued that the existence of family discord can negate application of the family attribution rules. It argued that because it is undisputed that the family cannot function as an economic unit, the attribution rules, built as they are upon that premise, are inapplicable.

Judge Higginbotham saw no ambiguity in the statute, and read the unambiguous statute as making no exceptions to the Section 318 attribution rules for family discord.

**Edward S. Kisscorni, CPA/MBA, Director of State and Local Tax**



**Echelbarger, Himebaugh, Tamm & Co PC:**

[edk@ehtc.com](mailto:edk@ehtc.com)

[5136 Cascade Rd SE Ste 2A](#)

[Grand Rapids, MI 49546-3728](#)

[www.ehtc.com/ehtc/salt.htm](http://www.ehtc.com/ehtc/salt.htm)

[www.MichiganStateAndLocalTax.com](http://www.MichiganStateAndLocalTax.com) (Blog)

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