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Michigan Business Tax (MBT): Unitary Business Group Determination – The Control Test

GRAND RAPIDS, MI – Monday, March 24, 2008 – There seems to be a lot of confusion on the control test for a "unitary business group" determination. Section 117(6) of the Michigan Business Tax Act (MBTA) [MCL 208.1117(6)] specifies that a "unitary business group" must pass a control test and one of two relationship tests. The control test requires that one of the U.S. persons own or control, directly or indirectly, *more than 50%* of the ownership interests with voting rights or similar rights of the other U.S. persons. The confusion surrounds the use of the term "indirectly." What does indirectly mean?

The Department of Treasury (Treasury) has repeated several times in their Frequently Asked Questions (FAQs) their intent to equate "indirectly" with "constructive ownership" and then jump to Internal Revenue Code (IRC) Section 318.

"The Department will follow IRC 318 or analogous authority to determine indirect, or constructive, ownership and control, except that the Department will apply IRC 318 to all ownership interests." [Treasury FAQs U6, U7, U9, U10 and U24]

I have heard from some CPAs and attorneys that the term "indirectly" cannot be equated with "constructive ownership" and therefore, the use of IRC Section 318 is misplaced. Well then, what does "indirectly" mean?

The following examples from the California Internal Procedures Manual, show the interaction of direct and indirect ownership:

Example 1:

Corporation A owns 50% of the stock of Corporation B and 25% of the stock of Corporation C. Corporation B owns 50% of the stock of Corporation C.

Corporation A does not own more than 50% of B, and B does not own more than 50% of C. Since A does not have a controlling interest in B, B's shares of C are not indirectly controlled by A. Therefore, A's direct and indirect interests in C are not sufficient to meet the ownership requirement.

Unity of ownership is not present with respect to A, B or C.

Example 2:

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Assume the same facts as in Example 1, except that A now owns 51% of the stock of B. All three corporations would now meet the ownership test. Since A now has a controlling interest in B, it indirectly owns 50% of C through B. When this indirect interest is added to A's 25% direct interest in C, ownership of more than 50% is established.

When we look at the MBTA, we cannot find definitions for "control, directly or indirectly; collectively or individually." However, IRC Section 318 is mentioned in the definition of "shareholder".

"Shareholder" means a person who owns outstanding stock in a business or is a member of a business entity that files as a corporation for federal income tax purposes. An individual is considered as the owner of the stock owned, directly or indirectly, by or for family members as defined by section 318(a)(1) of the internal revenue code. [MCL 208.1115(2)]

Please note the reference to IRC Section 318 is limited to 318(a)(1) which is merely attribution from members of a family. The Section 318 citation is identical as that contained in Section 36 of the Single Business Tax Act (SBTA). Was the intent of the legislature to limit attribution to only family members?

Treasury has said verbally that the legislative intent is the most expansive application of "unitary."

The Enrolled Summary of Senate Bill 94, which became Public Act 36 The Michigan Business Tax Act stated: "The goal of unitary filing is to reduce tax avoidance by eliminating the effectiveness of transferring financial transactions among the businesses." [Senate Fiscal Agency – June 29, 2007]

Although some may question the statutory authority for applying the attribution rules of Section 318, it is very clear from the Treasury FAQs, that Treasury will use the constructive ownership rules of IRC Section 318 in its entirety. Categories of relationship as found in IRC Section 318 include family members, partnerships and partners, estates and beneficiaries, trusts and beneficiaries, corporations and shareholders and holders of stock options. Does re-attribution also apply?

In FAQ U6, Treasury stated that where a group of companies who have a flow of value between them but are owned by two nonrelated persons, each owning 50%, they would NOT be considered a unitary business group. As the subject persons are described as nonrelated and each owning 50% of the group, the control test in section 117(6) is not met. Thus, these entities do not comprise a unitary business group. [Treasury FAQ U6]

In FAQ U24, Treasury stated that if five or fewer persons who are unrelated individuals, estates or trusts own a controlling interest in a brother-sister group of entities, they will NOT satisfy the control test for purposes of qualifying as a unitary business group. "No, so long as none of the five or fewer unrelated individuals, estates or trusts own more than 50% of the brother-sister group of entities." [Treasury FAQ U24]

Several CPAs and attorneys have questioned whether Treasury is truly applying IRC Section 318 as broadly as they believe the legislature intended.

Please stay tuned for more news and follow the [MichiganStateAndLocalTax Blog](#) for information as it becomes available.

If you have questions please feel free to contact me. I would be happy to be of assistance.

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Sincerely,

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