

Michigan – Individuals may combine income and apportionment from unitary flow-through businesses income

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In brief

On June 24, 2013, the Michigan Supreme Court held that individual taxpayers could combine the profits and losses from unitary flow-through businesses and apportion such income on the basis of the businesses' combined apportionment factors for purposes of the Michigan Individual Income Tax. The court also held that, during the 1994 and 1995 tax years, such apportionment could properly be applied to a foreign entity if the foreign entity and the individual taxpayer's in-state business were unitary. [[Malpass v. Department of Treasury](#), Mich. Sup. Ct., No. 144430 (6/24/13)]

In detail

Facts

In a consolidated action involving multiple taxpayers over different tax years, individual taxpayers received income from their unitary in-state and out-of-state pass-through entities for the 2001 to 2003 tax years. Some entities operated at a profit while others operated at a loss. The taxpayers attempted to combine the flow-through income from their respective businesses and then apportion the income using the businesses' combined apportionment factors. The Department required the income and loss from each pass-through entity to be apportioned separately.

For the 1994 and 1995 tax years, individuals were also shareholders of a domestic S-corporation and partners in two foreign general partnerships. The income and losses from the S-corporation and foreign partnerships flowed through to the owners for purposes of Michigan's individual income tax.

Individuals may combine income and apportionment from unitary pass-through entities

The court recognized that Michigan's Individual Income Tax Act (ITA) requires an individual taxpayer with business income from business activity both within and outside

the state to apportion such business income using formula apportionment. However, the ITA does not expressly require a particular method of apportionment (i.e., separate-entity reporting or combined reporting). The court observed that the issue in this case was whether the ITA precluded individuals from using the combined reporting method for their business income.

The court found that the ITA was broad enough to encompass both methods and therefore ruled in the taxpayers' favor. Accordingly, the taxpayers in this case were allowed to

combine the flow-through income from their respective unitary businesses and then apportion the income using the businesses' combined apportionment factors.

For prior years, the combined reporting method is available for foreign pass-through income

For the 1994 and 1995 tax years, the Department argued that the combined reporting method did not extend to income from unitary *foreign* pass-through entities. The court observed that the ITA, during the years at issue, contained no provision limiting apportionment only to domestic entities. Accordingly, the court found that a "unitary business with income from a business in a foreign country could be apportioned under the version of the ITA in effect during the tax years of 1994 and 1995."

Unitary analysis

Regarding the 1994 and 1995 tax years, the parties disputed whether a unitary relationship existed between the foreign partnerships and the domestic S corporation. The court recognized that a unitary finding was required before income and apportionment from the foreign partnerships could be aggregated under the combined reporting method. The court examined the following five factors in determining the existence of a unitary business: (1) economic realities, (2) functional integration, (3) centralized management, (4) economies of scale, and (5) substantial mutual independence. The court upheld the Tax Tribunal's factual finding that a unitary relationship existed. Accordingly, the individuals were permitted to combine the profits and

losses from their domestic and foreign pass-through entities and then apportion such income using the companies' combined apportionment factors.

The takeaway

Michigan has long adopted a separate entity approach to taxing income for individual income tax purposes. The forms created by Treasury have also forced this result. The interesting part of this decision is that the court indicated that both separate reporting and combined reporting is allowed so taxpayers seemingly have a choice. We may expect there to be tax law changes as a result of this decision, but in the meantime, taxpayers may want to consider filing amended returns and should consider the application of this decision on a prospective basis.

Let's talk

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