NewsAlert

Tax Accounting Services
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Key tax accounting considerations of the Michigan corporate income tax legislation and the repeal of the Michigan business tax

In summary

- *Date of Enactment (US GAAP):* May 25, 2011
- *Effective Date:* January 1, 2012
- *Taxpayers impacted:* Corporate entities, flow through entities.
- *Accounting Areas to consider:* Scope, accounting for tax law changes, special considerations for temporary differences, accounting for uncertainties, accounting for certificated credits, and disclosures

Michigan legislation enacted May 25, 2011, repeals the two-prong Michigan business tax (MBT) and implements a corporate income tax (CIT), effective January 1, 2012, for most taxpayers. The MBT remains in effect for MBT taxpayers with "certificated" MBT credits that timely elect to claim certificated credits until those credits are exhausted, with certain exceptions. [H.B. 4361, H.B. 4362, H.B. 4479, enacted 5/25/2011]

Summarized below are the key CIT and MBT provisions and their potential impact on accounting for income taxes under US GAAP. For more information on these and other provisions within the legislation, please see PwC's myStateTaxOffice article titled, "*Michigan replaces MBT with new corporate income tax*", dated May 25, 2011.

CIT overview

The CIT is a net income tax imposed only on C corporations and entities taxed as C corporations. The CIT definition of "corporation" excludes insurance companies and financial institutions, as those terms are defined in the law. Flow through entities are not subject to the CIT. The CIT statute defines a flow through entity as an entity that for the applicable tax year is treated as a subchapter S corporation under the IRC, a general partnership, a limited partnership, a trust, a limited liability partnership or a limited liability company that for the tax year is not taxed as a corporation for federal income tax purposes. However, as discussed in more detail below, corporate taxpayers with an ownership or beneficial interest in a flow through entity will still need to consider the implications of that ownership interest for both CIT nexus and CIT liability calculation purposes.

The CIT is effective January 1, 2012. Accordingly, calendar year taxpayers must compute a CIT liability for the first full tax year that begins on January 1, 2012, and each year thereafter, in many instances. In contrast, fiscal year filers, i.e., those companies with tax years that end on a date other than December 31, will need to compute two tax liabilities for a fiscal year that spans January 1, 2012. Those liabilities

include: 1) a CIT liability for the portion of their fiscal year that includes January 1, 2012, and forward; and 2) a two-prong MBT liability for the portion of their fiscal year running through December 31, 2011.

CIT taxpayers may elect to use one of two alternative methods in computing the CIT for the first tax year that spans the January 1, 2012 effective date. The first method requires a taxpayer to determine a CIT liability as if the CIT was in effect from the first day of the tax year, and to multiply the CIT liability by a fraction, the numerator of which is the number of months in the first tax year and the denominator of which is the number of months in the taxpayer's annual accounting period. In the alternate, a taxpayer may use another accounting method satisfactory to the Michigan Department of Treasury.

The CIT is imposed at the rate of six percent and applies to the allocated and apportioned CIT tax base. The CIT tax base is generally federal taxable income with some exclusions plus specific Michigan additions and subtractions.

While not specifically listed as a modification to business income, based on allocation and apportionment provisions that apportion income attributable to flow through entities with Michigan business activity at the flow through entity level, it appears that CIT taxpayers would therefore adjust their pre-apportioned business income to exclude the flow through entities business income when determining the CIT tax base. Allocated/apportioned flow through entity business income would then be included in the taxpayers' post-apportioned CIT income.

The nexus limitation of P.L. 86-272[1] applies for CIT purposes. That said, the statute specifically provides that the CIT is imposed on any C corporation with "substantial nexus," "business activity," or an ownership or beneficial interest in a flow through entity with business activity in the state. "Substantial nexus" is defined as a physical presence in the state for a period of more than one day during the tax year, if the taxpayer actively solicits sales in the state and has gross receipts of $350,000 or more that are sourced to the state; ***or*** an ownership or beneficial interest in a flow through entity, directly, or indirectly through one or more other flow through entities, that has substantial nexus in this state. "Business activity" is defined as a range of activities engaged in with the object of gain, benefit or advantage for the taxpayer.

The CIT allows taxpayers to deduct business losses incurred after December 31, 2011. CIT business losses may be carried forward 10 years.

The CIT tax base is apportioned using a single factor formula based on sales. Sales of tangible personal property are sourced on a destination basis and sales of other than tangible personal property are sourced using a market-based sourcing methodology. Business income from a flow through entity with Michigan business activity is apportioned at the flow through entity level and included in the post-apportioned income of the corporate taxpayer.

The CIT mandates combined reporting by a unitary business group. The report must include each unitary member that is a US person and a C corporation, or entities taxed as C corporations for federal income tax purposes, other than a foreign operating entity. Business income earned by an insurance company and/or financial institution (as those terms are defined) that are also included in the unitary business group of non-insurance companies and financials is not included in the combined report. A unitary business group is treated as a single taxpayer, and intercompany transactions are eliminated in

[1] Public Law 86-272 (P.L. 86-272) limits a state's ability to impose income tax on a business entity. Specifically, P.L. 86-272 prohibits the imposition of a tax measured by income on a taxpayer whose only activity carried on within the state is the solicitation of orders for the sale of tangible personal property, where the orders are sent outside the state for approval and if approved are filled and delivered from a stock of goods located outside the state.

computing combined income and apportionment factors. Combined income is sourced using a *Finnigan*[2] approach.

Tax regimes currently in existence under the MBT for insurance companies and financial institutions are effectively retained under the CIT. Thus, insurance companies will continue to be subject to the greater of a tax imposed at the rate of 1.25 percent of gross direct premiums written on property or risk located or residing in the state or the retaliatory tax. Insurance companies retain certain insurance-related credits. Financial institutions will continue to be subject to tax based on average net capital at a rate of 0.29 percent.

Credits allowed under the MBT are not retained, with the exception of the "alternate tax credit" for taxpayers with gross receipts that do not exceed $20 million and adjusted gross income that does not exceed $1.3 million. However, a taxpayer (which includes a unitary group subject to combined filing) may elect in the first tax year ending after December 31, 2011, to continue to file MBT returns, if the taxpayer has certificated credits. An election to remain subject to the MBT applies to all members of a unitary group.

If the election to file under the MBT is made, a taxpayer remains subject to the MBT until the certificated credits or certificated credit carryforwards are exhausted, in most instances. An electing taxpayer's MBT liability (after all credits, deductions, and exemptions) is effectively the greater of: 1) the calculated two-prong MBT liability, after all credits, deductions, exemptions, and unused credit carryforwards; or 2) the calculated CIT liability, less any certificated credits. It appears that the MBT unitary group, which may include flow through entities, is used to determine the CIT "greater of" liability, even though the CIT statutes specifically exclude flow through entities from the CIT.

MBT losses incurred before January 1, 2012, do not carryover to the CIT; however, such losses may be used by an electing taxpayer to compute the MBT component of the "greater of" liability.

"Certificated credits" include the following credits: the early stage venture capital credit; brownfield redevelopment credits; Michigan Economic Growth Authority ("MEGA") credits for photovoltaic technology, employment, anchor company payroll, federal government employment, anchor company taxable value, polycrystalline silicon manufacturing, high-power energy batteries, hybrid technology research and development; media production and infrastructure; historic preservation; renaissance zone; natural resources and environmental protection; and motorsports entertainment complexes.

Key tax accounting considerations

Scope. As noted in PwC's Dataline 2007-17, *The Financial Reporting Implications of Changes in the Michigan Tax System, updated January 23, 2008,* both components of the MBT (i.e., the modified gross receipts tax and the business income tax) are accounted for as an income tax in accordance with *Accounting Standards Codification* 740 (ASC 740). The CIT is an income tax and, therefore, should also be accounted for as an income tax in accordance with ASC 740. However, because the taxes imposed on insurance companies and financial institutions are not based on net income, they continue to fall outside the scope of ASC 740.

[2] The "*Finnigan*" approach has its genesis in *Appeal of Finnigan Corp. (Finnigan I),* 88-SBE-022 (Aug. 25, 1988). Simply stated, *Finnigan* holds, in the context of a combined income tax report, that the term "taxpayer" applies to the combined group as a whole rather than to individual group members. Accordingly, each and every member in a combined group is deemed to have nexus in a state once any member of the group has nexus in the state. As a result, a non-nexus, individual combined group member cannot claim the protections of P.L. 86-272 in determining its sales in a state when any member of the combined group has nexus in the state.

Accounting for tax law changes. The income tax accounting standard requires that the effects of a change in tax law be accounted for in the period including the date of enactment. The tax effects of a change in tax law should be recorded as a discrete item in the period in which the law is enacted. For example, calendar year taxpayers will need to reflect the impact of the tax law change in second quarter financials while fiscal year filers will need to record the impact of the change in the quarter that includes May 25, 2011. The new rate will then be used in the entity's annual effective tax rate for the remainder of the year.

The effects, both current and deferred, are reported as part of the tax provision attributable to continuing operations, regardless of the category of income in which the underlying pre-tax income/expense or deferred tax asset/liability was or will be reported, such as discontinued operations or other comprehensive income.

Special considerations for temporary differences. As a result of the effective date of the CIT and repeal of the MBT, a detailed analysis may be necessary to determine the correct taxing scheme and rate to apply to reversing temporary differences. Under US GAAP, the applicable tax rate is the enacted rate expected to apply when temporary differences are expected to be settled or realized and, therefore, a different tax rate could apply for temporary differences reversing before and after the new law takes effect.

Fiscal year filers will have a prorated tax rate for the tax year that includes January 1, 2012. Absent an election to remain subject to the MBT, fiscal year filers will need to determine the period of the tax year to which the MBT and CIT will apply and adjust deferred tax assets and liabilities accordingly.

Taxpayers that elect to remain subject to the MBT may face challenges in determining the appropriate tax rate to apply to deferred tax assets and liabilities and the timing for when the taxpayer will no longer be eligible to file the MBT and instead becomes a CIT filer.

Taxpayers, other than those that elect to remain subject to the MBT, will need to revalue their deferred tax assets and liabilities when accounting for the impact of the repeal of the MBT and adoption of the CIT. This includes the deferred tax asset that may have been established when Michigan enacted legislation providing for a "FAS 109" deduction. This asset would have been established under statutory provisions that allowed Michigan taxpayers deductions for the amounts necessary to offset certain deferred tax liabilities that resulted upon enactment of the MBT as of July 12, 2007.

Where a taxpayer elects to remain subject to the MBT to utilize certificated credits, it may utilize MBT business losses carryforwards to compute the MBT "greater of" liability. In addition, it appears taxpayers may also utilize CIT NOLs generated in MBT-electing years to compute its "as if" CIT liability. However, it appears CIT losses generated in MBT-electing years do not carry over for CIT purposes to post MBT-electing years. As such, taxpayers must evaluate whether or not a valuation allowance should be established or existing valuation allowances adjusted against deferred tax assets attributable to prior MBT losses which it anticipates may be unutilized when applying the guidance of ASC 740-30. In addition, taxpayers must evaluate whether a deferred tax asset should be recorded or a valuation allowance should be established for CIT loss carryovers generated in MBT-electing years.

As noted above, the CIT allows taxpayers to deduct business losses incurred after December 31, 2011 and they may be carried forward 10 years. MBT losses incurred before January 1, 2012, do not carry over to the CIT. As such, taxpayers should evaluate whether or not the deferred tax asset for MBT

losses should be written off or if a valuation allowance should be established or existing valuation allowances adjusted for prior MBT losses which it anticipates will not be utilized.

Accounting for uncertainties. As noted above, flow through entities are not considered taxpayers under the CIT. Rather, income earned by a flow through entity with business activity in Michigan is included in the CIT tax base of its corporate owners. The amount of business income to include is based on the apportionment factor of the flow through entity, allocated to the taxpayer and included as part of the taxpayer's post-apportioned CIT tax base.

While the statutes address how to treat the business income earned by a flow through entity with Michigan business activity, the statutes do not specifically address the treatment of a flow through entity with no Michigan business activity. One potential viewpoint is that the income and factors of flow through entities without Michigan business activity would "flow up" to its owner. An alternative viewpoint is that flow through entities without Michigan business activities are treated similar to those that have Michigan business activity. Given the potential differing viewpoints, taxpayers will need to consider its position in assessing its uncertain tax positions using the recognition and measurement guidance under ASC 740-10.

Based on the CIT definitions of “taxpayer” and “flow through entity,” entities such as single member limited liability companies that for the tax year are not taxed as C corporations (i.e., are disregarded) appear to be considered flow through entities, but there is some uncertainty in this regard. Taxpayers should analyze the law and determine the appropriate position with respect to concluding which entities are properly characterized as flow through entities, how to treat those flow through entities for purposes of the CIT and whether, under ASC 740-10, an uncertain tax position exists that must be assessed.

Accounting for certificated credits. For those companies electing to remain subject to the MBT, it is important to determine the appropriate accounting model to apply when accounting for the certificated credits and overall financial statement impact of the election. Businesses will need to be cognizant of the mechanics of the specific credit at issue, including the credit computation, the period over which a credit can be claimed, the entity earning the credit, and whether the credit is assignable or refundable. For example, the MEGA employment credit, which equals a portion of employer payroll and health care costs incurred with respect to certain employees, is claimed against the MBT liability, and excess credits are fully refundable in any tax year. In general, where a credit is fully refundable without regard to taxable income or income tax and is not measured by reference to income, the credit is analogous to a government grant or assistance and would typically not be accounted for as a reduction to income tax expense. In contrast, the renaissance zone credit is a nonrefundable credit, so it may be accounted for as a reduction to income tax expense.

Disclosures. Companies should consider disclosure in their financial statements of the impact of the enacted changes in tax law. The current year’s reconciliation of the effective tax rate should include a reconciling item for the effect of this enacted law change if the effect is considered “significant.” Significant is defined by Rule 4-08(h) of SEC Regulation S-X as an individual item that is more than 5 percent of the amount computed by multiplying pre-tax income by the statutory tax rate. In addition, when changes in tax laws are enacted subsequent to the balance sheet date, but before the financial statements are released, the effect on existing deferred tax assets or liabilities may need to be disclosed.

Companies should also consider whether enhanced disclosures over and above the required minimums should be made to assist users of accounts in understanding the implications of the changes.

Contacts

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