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State Tax Treatment of Federally Disregarded Entities: Michigan's *Kmart* Saga

The implications of Kmart extend beyond the situation presented in that case and, as discussed herein, may continue also with regard to the Michigan Business Tax, which replaced the state's Single Business Tax in 2008.

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The decision in *Kmart Michigan Property Services, LLC v. Department of Treasury* [1] (*Kmart*) and related subsequent developments dealing with the Michigan Single Business Tax (SBT) treatment of a single-member limited liability company (SMLLC) present an interesting study in tax policy, procedure, and legislative action. The implications extend beyond the situation presented in that case and, as discussed further below, may continue also with regard to the Michigan Business Tax (MBT), which replaced the SBT effective in January 2008.

The Issue

The issue discussed here is whether, for Michigan SBT purposes, a federally disregarded entity like a SMLLC should be (1) treated as it is for federal tax purposes, i.e., disregarded and taxed as though its assets and activities were part of its sole member's assets and activities, or (2) taxed as a separate taxpayer.

Historical treatment by Michigan. The now repealed Michigan SBT Act that was in effect through December 2007 provided that every "person" with business activity in Michigan was required to pay the SBT. [2] It further provided that, for purposes of the SBT, a "person" was "an individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit." [3] It did not specifically address a "limited liability company" (LLC). As the use of LLCs became more prevalent, and after the "check-the-box" regulations were adopted at the federal income tax level, [4] taxpayers sought clarity on how Michigan would tax a federally disregarded entity.

In November 1999, the Michigan Department of Treasury issued Revenue Administrative Bulletin (RAB) 1999-9 (11/29/99, retroactively effective to 1/1/97, the effective date of the federal check-the-box regulations) in which it determined that Michigan follows the federal check-the-box regulations, and thus a SMLLC would be taxed in a manner similar to the federal tax treatment, i.e., disregarded as a separate taxpayer and treated as part of its owner. In the RAB's "Conclusion I," the Department stated: "If a single member unincorporated entity is disregarded as an entity separate from its owner (a tax nothing) at the federal level it is treated as a branch, division, or sole proprietor for SBT purposes." Similarly, the Department addressed the SBT treatment of another type of federally disregarded entity, a "qualified subchapter S subsidiary" (QSUB), in RAB 2000-5 (6/19/00), stating: "Michigan conforms to the federal QSub election for SBT purposes.... [T]he S corporation and its QSub must file a single return."

The *Kmart* Case

Michigan's treatment of SMLLCs and QSUBs as disregarded entities for SBT purposes was applied rather uneventfully ... until the *Kmart* case. Kmart Michigan Property Services, LLC (KMPS) and its sole member, Kmart Corporation, were taxed more favorably under the SBT by having KMPS file as a taxpayer separate from its member. [5] Accordingly, the two entities filed separate SBT returns, taking the position that KMPS met the definition of "person" under the SBT Act and, thus, qualified to file a separate return. The Department challenged such filings and mandated that the two entities file a single SBT return, applying its position set forth in RAB 1999-9 that a SMLLC that was disregarded for federal tax purposes must be disregarded also for SBT purposes.

Tax Tribunal agrees with the taxpayer. The case was litigated before the Michigan Tax Tribunal, which held that KMPS was a "person" under the SBT Act and that KMPS and its member were not required to file a single return as mandated by RAB 1999-9. The Tribunal noted in its opinion that "[a] plain reading of the phrase 'or any other group or combination acting as a unit' should be construed to cover the same kind, class, character or nature as those entities specifically enumerated," such that "[t]he concluding phrase ... encompasses business entities that are not enumerated or lack precise legal identification." [6] Based on that interpretation, the Tribunal concluded that a limited liability company, though not expressly identified in the SBT Act, fits within the statutory definition of "person" whether it has one or more members. The Tribunal rejected the Department's argument that KMPS's elected tax status for federal tax purposes overrode its legal status for state tax purposes.

The Tribunal noted that, as conceded by the Department, the Department's policies as expressed in an RAB do not have the force of a legal requirement. It observed that the Michigan Revenue Act (Mich. Comp. Laws Ann. §205.1 *et seq.,* pursuant to which various Michigan taxes, including the SBT, are administered) allows the Department to periodically issue bulletins that explain current Department interpretations of current state tax laws. [7] The Tribunal noted also that the Department did not promulgate its position as a rule under its statutorily provided tax rule-making authority in accordance with the Michigan Administrative Procedures Act (APA) that requires reasonable notice and public hearing. [8]

Appellate court affirms. On appeal, the Michigan Court of Appeals affirmed the Tribunal's decision. The court of appeals noted that even though RAB 1999-9 is not legally binding, it reflects the Department's interpretation of a statute the Department is charged with enforcing, and thus is entitled to respectful consideration. [9] Nevertheless, the court concluded that in *Kmart,* the Department's legal rationale was inconsistent with

the plain language of the SBT Act, thus negating the position taken by the Department in the RAB. In September 2009, the Michigan Supreme Court declined to grant a further appeal in *Kmart.*

The Aftermath of the *Kmart* Case

Following *Kmart,* the Department was in a quandary. It was concerned that it could get whipsawed if those taxpayers that preferred disregarded-entity treatment were to follow the Department's administrative position in RAB 1999-9, while taxpayers that could benefit from separate taxation of their SMLLCs would follow the *Kmart* decision. After much deliberation, the Department responded by issuing its "Notice to Taxpayers Regarding Kmart Michigan Property Services, LLC v. Dep't of Treasury, the Single Business Tax, RAB 1999-9, and RAB 2000-5" (2/5/10, the "Kmart Notice"). The Kmart Notice covered the SBT treatment of all federally disregarded entities, including SMLLCs and QSUBs. The Department's pronounced position essentially was as follows:

> (1) It would follow the *Kmart* case.
> (2) Any federally disregarded entity that was included as part of its owner's SBT return must file a separate SBT return for all open tax years. (No regular statute of limitations applied because no separate returns were originally filed for the disregarded entity that would start the running of the statute.)
> (3) The owner of a disregarded entity that had included the entity in its SBT returns must file amended SBT returns for all open years to remove the activities of the disregarded entity that were included. (In this situation, amended returns could be filed only for years for which the statute was still open—generally four years from the date of filing, unless extended or suspended because of an audit or litigation.)

The Department gave taxpayers until 9/30/10 to file any required original or amended returns without penalty. In the Kmart Notice, the Department concluded that in accordance with the *Kmart* decision—and consistent with a series of cases [10] that require the Department to give judicial decisions full retroactive effect even in the presence of contrary guidance issued by the Department prior to the date of the decision—it would retroactively apply the holding of *Kmart* to all open tax years.

The validity of the Kmart Notice was questionable for a variety of reasons, including that (1) it may have misapplied the holding of *Kmart,* (2) it may have been improperly applied retroactively, and (3) it was not promulgated as a rule under the APA and not even issued as an RAB as permitted by the Michigan Revenue Act. Subsequent legislation, however, may make the question of its validity moot.

The Legislative Fix

Many taxpayers have SMLLCs and/or QSUBs in their business structures and were affected by the Department's new position expressed in the Kmart Notice. Countless numbers of SBT returns would be required to be filed or amended. Because of the mismatch on the open tax years (in many cases, the open separate-return tax years for the now separately taxed entity would go back further in time than the open tax years of the sole owner), many businesses would pay much more in taxes than if they had originally filed as separate taxpayers.

After lobbying by the State Bar, the Michigan Association of CPAs, and various business groups, the Department supported a legislative amendment (the "Kmart Amendment") to §27a of the Michigan Revenue Act to remedy the situation (there was no attempt to amend the now repealed SBT Act). On 3/31/10, H.B. 5937 (2010 Pub. Act No. 38) was signed into law, adding Mich. Comp. Laws Ann. §§205.27a(8) and (9).

Basically, the Kmart Amendment reinstates the law governing disregarded entities under the SBT in effect prior to *Kmart,* as follows:

> (1) The Department is prohibited from assessing any additional SBT or reducing any overpayment because an entity disregarded for federal tax purposes (e.g., a SMLLC or QSUB) was included as part of its owner's Michigan tax return. Taxpayers are prohibited from seeking SBT refunds based on a separate filing position if that is not how they originally filed.
> (2) The Department is prohibited from requiring a disregarded entity to file a separate tax return.
> (3) A taxpayer that included a disregarded entity in its return may not claim a refund by filing amended returns for the disregarded entity as a separate taxpayer. This provision does not bar a refund claim by a disregarded entity that originally filed a return as a separate taxpayer.
> (4) The legislation exempts select taxpayers (e.g., Kmart) from its application by providing that it does not affect any refund that a taxpayer received as a result of a final order of a court of competent jurisdiction, where all appeal rights were exhausted prior to 2/12/10 and the taxpayer was a party to the proceeding (see H.B. 5937, Enacting §1).

The legislation provides also that the Kmart Amendment is curative, applies retroactively, and is intended to correct any misinterpretation concerning the treatment of a federally disregarded entity that may have been caused by the *Kmart* decision. [11] Unless the Kmart Amendment is challenged, it appears that the controversy concerning the SBT treatment of a federally disregarded entity is over. On 4/12/10, the Department issued a Notice in which it rescinded its Kmart Notice and concluded that RABs 1999-9 and 2000-5 reflect the correct interpretation of the law regarding the treatment of disregarded entities under the SBT. The new Notice further concluded that all returns, assessments, refunds, and voluntary disclosure agreements involving disregarded entities will be administered consistent with H.B. 5937 and RABs 1999-9 and 2000-5.

Michigan Business Tax Implications

As noted above, the Michigan SBT was replaced by the Michigan Business Tax (MBT), effective 1/1/08. [12] In connection with the MBT, once again there is a question as to the tax treatment of a federally disregarded entity (e.g., a SMLLC or QSUB). The Department of Treasury has issued some administrative interpretations and explanations of the MBT Act in a "question-and-answer" format called "Frequently Asked Questions" (FAQs) (all FAQs are available on the Department's website, at www.michigan.gov/treasury). In one of these FAQs, the Department has taken the position that it will follow the federal income tax treatment of a federally disregarded entity, stating: "In general, the MBT conforms to the federal check-the-box regulations.... Thus a single member entity, including limited liability companies, disregarded for federal tax purposes will be similarly disregarded under the MBT. In other words, an entity disregarded for federal tax purposes will be treated as a sole proprietorship, branch, or division of its owner. The owner of the disregarded entity will be the taxpayer under the MBT.... The MBT also conforms to the federal QSub election. Under federal tax provisions, the separate existence of a QSub is ignored.... For MBT purposes, the QSub is disregarded as an entity

and the S corporation and its QSub must file a single return (or as part of the combined return of a unitary business group)." [13]

In another FAQ, the Department concludes: "Although a limited liability company (LLC) is defined as a 'person' under the MBTA, MCL 208.1113(3), to the extent that such an entity is a single member LLC disregarded for federal tax purposes, the owner of the LLC is the MBT taxpayer, and the disregarded entity is treated as a sole proprietorship, branch or division of its owner." [14]

An FAQ has even less authority than a Department-issued RAB, such as the RAB that was overturned in *Kmart.* Query whether a legislative fix will be made to clarify SMLLC and QSUB treatment under the MBT. The MBT, however, incorporates a unitary filing approach that generally requires a combined return for any two or more entities that have (1) greater than 50% common ownership or control, and (2a) a flow of value between the entities or (2b) business activities or operations that are integrated with, are dependent upon, or contribute to each other. Therefore, relatively few SMLLCs and QSUBs likely would not be required to combine with their sole owner in a unitary combined return even if they would otherwise be regarded as separate taxpayers.

Conclusion

The Kmart saga is an interesting study in that the Michigan Department of Treasury attempted to adopt a position that, in general, was favorable to most taxpayers with related federally disregarded entities—i.e., similar to the federal treatment, such an entity was disregarded as a separate taxpayer and treated as part of its owner for Michigan tax purposes. When Kmart challenged that treatment, the Department's position was overturned by the courts, and the consequences became harshly unfavorable to most taxpayers in that group. The outcome underscores the procedures that should be followed to effectively implement tax policy, and illustrates how corrective legislation can sometimes provide a retroactive fix. **[]**

Sidebar

Practice Note: Disregarded Entities and Income vs. Other Taxes

Virtually all states that impose income and/or franchise taxes now conform to the federal "check-the-box" regulations with regard to those taxes. Nevertheless, Michigan, as well as some other jurisdictions (e.g., Florida, Georgia, the District of Columbia) that have adopted such conformity do not conform to the "check-the-box" regulations for purposes of sales, use, and other related taxes.

END NOTES

[1] 283 Mich. App. 647, 770 NW2d 915 (2009), *app. den.* Mich. S.Ct., 9/28/09.

[2] Mich. Comp. Laws Ann. §208.31(1).

[3] Mich. Comp. Laws Ann. §208.6(1).

[4] Treas. Regs. §§301.7701-1 through 301.7701-3. For background on the "check-the-box" regulations, see Peabody, "States Generally Endorse Check-the-Box but Key Issues Remain," 7 J. Multistate Tax'n 206 (Nov/Dec 1997).

[5] During the period at issue, KMPS had three employees and was responsible for winding up the business affairs of Builders Square, its former subsidiary, whose assets were sold to a third party.

[6] As quoted by the Michigan Court of Appeals in Kmart Michigan Property Services, LLC v. Dept. of Treasury, *supra* note 1.

[7] Mich. Comp. Laws Ann. §205.3(f).

[8] Mich. Comp. Laws Ann. §§24.201 to 24.378.

[9] Citing In re Complaint of Rovas Against SBC Michigan, 482 Mich. 90, 754 NW2d 259 (2008).

[10] Syntex Laboratories v. Dept. of Treasury, 233 Mich. App. 286, 590 NW2d 612 (1998); Rayovac Corp. v. Dept. of Treasury, 264 Mich. App. 441, 691 NW2d 57 (2004); J.W. Hobbs Corp. v. Revenue Div., Dept. of Treasury, 268 Mich. App. 38, 706 NW2d 460 (2005); Int'l Home Foods, Inc. v. Dept. of Treasury, 477 Mich. 983, 725 NW2d 458 (2007). Int'l Home Foods, as well as the earlier decisions in Hobbs and Rayovac, were discussed in Shop Talk, "Michigan High Court OKs Treasury's Retroactive Application of Case Law Contrary to Agency's Own Interpretive Ruling," 17 J. Multistate Tax'n 42 (July 2007).

[11] H.B. 5937, 3/31/10 (2010 Pub. Act No. 38), Enacting §1.

[12] See Grob and Roberts, "The Michigan Business Tax Replaces the State's Much-Vilified SBT," 17 J. Multistate Tax'n 8 (October 2007), and "Michigan Business Tax Update: Significant Amendments Enacted as the New MBT Goes Into Effect," 18 J. Multistate Tax'n 14 (Mar/Apr 2008).

[13] MBT FAQ No. Mi28, 4/15/08.

[14] MBT FAQ No. B17, 2/28/08.