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MICHIGAN BUSINESS TAX UNITARY BUSINESS GROUP CONTROL TEST

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

RAB 2010-1

Under the Michigan Business Tax ("MBT"), a unitary business group is two or more persons that satisfy both a *control test* and one of two *relationship tests*.¹ A unitary business group is a single taxpayer under the MBT and must file a combined return.² Foreign persons and foreign operating entities cannot be included in a unitary business group.³

This Revenue Administrative Bulletin ("RAB") describes the *control test* used in MCL 208.1117(6). If a group of entities satisfies the control test, that group of entities will constitute a unitary business group if that same group also satisfies one of two relationship tests. This RAB does not define or describe either of the relationship tests.

ISSUES

- I. How is a unitary business group defined under the MBT?
- II. What is the control test under the MBT?
- III. What are controlled groups of entities?
- IV. How do voting agreements affect the control test?
- V. How is control determined for nonstock nonprofit organizations?

¹ MCL 208.1117(6).

² MCL 208.1117(5), 208.1511.

³ MCL 208.1117(6).

- VI. How is a unitary business group determined if one entity is a member of more than one controlled groups of entities?
- VII. What is "indirect" ownership?

CONCLUSIONS

I. UNITARY BUSINESS GROUP DEFINED

Under the MBT, a unitary business group is defined as:

a group of United States persons, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.⁴

A group of U.S. persons must meet both a control test and one of two relationship tests before that group will be a unitary business group.

II. CONTROL TEST DEFINED

The control test is satisfied when one person owns or controls, directly or indirectly, more than 50% of the ownership interests with voting or comparable rights of the other person or persons.

A person owns or controls more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of another person if that person owns or controls, directly or indirectly, (1) more than 50% of the total combined voting power of all ownership interests with voting (or comparable) rights *or* (2) more than 50% of the total value of all ownership interests with voting (or comparable) rights. "Ownership interest with voting rights" includes all classes of stock in a corporation entitled to vote that possess the power to elect the membership of the board of directors of the corporation. "Ownership interests that confer comparable rights to voting rights" includes instruments, contracts, agreements, or other authority demonstrating an ownership interest in that entity that confers power in the owner to vote in the selection of the management of that entity.

Example 1. Corporation A is a general partner in Limited Partnership X with a 10% interest. The remaining 90% interest in Limited Partnership X is held by a variety of other entities and individuals as limited partners. Under Limited Partnership X's partnership agreement, the limited partners may not vote in the selection of the management of Limited Partnership X. Corporation A owns

⁴ MCL 208.1117(6).

100% of the ownership interests that confer comparable rights to voting rights of Limited Partnership X.

III. CONTROLLED GROUPS OF ENTITIES

A person owns or controls more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of another person if that person owns or controls (1) more than 50% of the total combined voting power of all ownership interests with voting (or comparable) rights *or* (2) more than 50% of the total value of all ownership interests with voting (or comparable) rights. Entities that satisfy the MBT control test constitute "controlled groups of entities." For purposes of this RAB, an entity includes a sole proprietorship. Controlled groups of entities are described below.

(A) Parent-Subsidiary Controlled Group of Entities. A parent-subsidiary controlled group of entities satisfies the control test. A parent-subsidiary controlled group of entities means any group of one or more chains of entities connected through ownership with a common parent if (1) the common parent directly or indirectly owns more than 50% of the ownership interests with voting or comparable rights of at least one other entity, and (2) more than 50% of the ownership interests with voting or comparable rights of each entity other than the common parent is owned directly or indirectly by one or more of the other entities.

Example 2. Corporation A owns 51% of Corporation B, which owns 51% of Corporation C, which owns 51% of Corporation D. The common parent owns more than 50% of the stock in at least one other entity (Corporation B), and more than 50% of the stock of each entity other than the common parent is owned by at least one other entity in the chain. Corporations A, B, C, and D are part of a parent-subsidiary controlled group of entities and satisfy the control test for unitary business groups.

Example 3. Same facts as Example 2, except Corporation C is a foreign person. Corporations A, B, and D are part of a parent-subsidiary controlled group of persons and satisfy the control test for unitary business groups. Corporation C, as an intervening foreign person, is still used to determine ownership and control, but is excluded from the unitary business group because it is not a United States person as required under MCL 208.1117.

(B) Brother-Sister Controlled Group of Entities. A brother-sister controlled group of entities may also satisfy the control test. A brother-sister controlled group of entities means two or more entities connected through common ownership where one such entity indirectly owns more than 50% of the ownership interests with voting or comparable rights of one or more of the other sibling entities.

Example 4. An individual owns 51% each of a pair of limited liability companies taxed as partnerships – One LLC and Two LLC. Under Section VII of this RAB, One LLC indirectly owns 51% of Two LLC. One LLC and Two LLC constitute a

brother-sister controlled group of entities and meet the control test for unitary business groups.

Example 5. Two unrelated individuals each own 50% of Corporation H and Corporation I. Under Section VII of this RAB, Corporation H indirectly owns 100% of Corporation I. Corporation H and Corporation I constitute a brother-sister controlled group of entities and meet the control test for unitary business groups.

Example 6. ForeignCo, a foreign corporation, owns 100% of Corporation Q and Corporation R, both U.S. persons. As a foreign person, ForeignCo cannot be a member of a unitary business group. However, Corporation Q is the indirect owner – through ForeignCo – of 100% of Corporation R, and *vice versa*. Corporation Q and Corporation R meet the control test for unitary business groups.

(C) Combined Controlled Group of Entities. A combined controlled group of entities satisfies the control test. A combined controlled group of entities means three or more entities each of which is a member of a parent-subsidary controlled group of entities or brother-sister controlled group of entities and one of which is a common parent entity of a parent-subsidary controlled group of entities and also is included in a brother-sister controlled group of entities.

Example 7. An individual owns 51% each of a pair of corporations – Corporations L and M. Corporation L owns 51% of Corporation N, which owns 51% of Corporation O. Corporation L is the common parent of the L, N, and O parent-subsidary controlled group of entities and is also a member of the L and M brother-sister controlled group of entities. Corporations L, M, N, and O are members of a combined controlled group of entities and meet the control test for unitary business groups.

(D) Excluded Ownership Interests. For purposes of determining ownership or control under the control test, the Michigan Department of Treasury (the "Department") will apply IRC 1563(c), other than IRC 1563(c)(2)(B), to exclude certain ownership interests from determination of ownership and control, except that the Department will apply IRC 1563(c) to all forms of ownership interests and not just corporate stock.

Example 8. Corporation X owns 50% of Partnership Y. The remainder of Partnership Y is owned by an individual who is also a principal stockholder under IRC 1563(c) of Corporation X. The individual's ownership interest in Partnership Y is treated as an excluded ownership interest under IRC 1563(c) as applied to the MBT. For purposes of the control test for unitary business groups, Corporation X owns 100% of Partnership Y.

(E) Controlled Group of Entities Without Common Control. In certain circumstances, the attribution rules of Section VII of this RAB may result in a controlled group of entities that are not in fact under the control of a member of the controlled group or under common control of

any person. A controlled group of entities such as this may fail to satisfy control standards for unitary businesses generally described by U.S. Supreme Court precedent. In most of these cases, the controlled group of entities in question would fail the relationship test under MCL 208.1117(6). However, if a controlled group of entities determines – despite satisfying the control test as described in this RAB and the relationship test under MCL 208.1117(6) – that the members of the controlled group of entities are not under common control of a person (including a member of the purported controlled group) or group of related persons, then that controlled group of entities will not satisfy the control test for purposes of MCL 208.1117(6). One or more persons within the purported controlled group may nonetheless comprise one or more controlled groups of entities or may be required to file separate returns.

Example 9. An individual owns a 20% interest in Partnership P and a 100% interest in Corporation C. Corporation C owns 100% of Corporation D. Under Section VII of this RAB, Partnership P indirectly owns 100% of Corporation C. Furthermore, Partnership P, Corporation C, and Corporation D comprise a combined controlled group of entities. If the members of this combined controlled group of entities determine that Partnership P, Corporation C, and Corporation D satisfy the relationship test, but are not under the common control of a person or group of related persons, then the controlled group of entities will not satisfy the control test for purposes of MCL 208.1117(6). However, even if Partnership P, Corporation C, and Corporation D do not satisfy the control test, Corporation C and Corporation D do comprise a parent-subsidiary controlled group of persons that will satisfy the control test. Furthermore, Partnership P may be required to file a separate return under the MBT.

IV. VOTING AGREEMENTS

For purposes of this RAB, in determining whether the ownership interests owned by a person possess voting (or comparable) rights, the Department presumes the following subject to rebuttal by the taxpayer:

(1) Unless noted otherwise below, ownership interests will be considered as possessing the voting rights accorded to such interests by statute, organization documents filed with the state, by-laws, certificates, agreements, or other authority.

(2) If there is any agreement that an owner will not vote his or her interests in an entity, the formal voting rights possessed by his or her interests will be disregarded in determining the percentage of ownership interests with voting rights owned by the other owners of the entity.

(3) If there is any agreement that an owner will vote his or her ownership interests in the manner specified by another owner of the entity, the ownership interests with voting rights owned by the first owner will be considered to be owned by the other owner.

(4) If an owner transfers voting power by proxy, voting trust, agreement, or similar device, and that transfer is revocable by the transferor, then the transferor shall be considered to be the owner of any ownership interest with voting rights otherwise transferred.

However, if there is any evidence of an implied or oral agreement or concerted action between or amongst owners or other persons, the Department will examine all of the facts and circumstances in determining whether the ownership interests owned by a person or persons possess voting (or comparable) rights.

V. NONSTOCK NONPROFIT ORGANIZATIONS

For entities without stock or other forms of ownership interests, such as nonstock nonprofit organizations, a parent entity controls more than 50% of the ownership interests with voting or comparable rights of the nonstock nonprofit organization if more than 50% of the directors or trustees of that organization are either representatives of or controlled by the parent organization.

VI. ENTITY IN MORE THAN ONE CONTROLLED GROUP OF ENTITIES

If, under this RAB, an entity is a member of more than one controlled group of entities, the entity shall be treated as a member of the controlled group with respect to which it satisfies the relationship test under MCL 208.1117. If the entity satisfies the relationship test with more than one of those groups, it shall elect to be treated as a member of only one of the controlled groups in question. This election shall remain in effect until the unitary relationship between the entity and the rest of the members of its elected controlled group is discontinued, or until revoked with the approval of the Department.

Similarly, if the application of this RAB results in a group of entities that comprise two or more overlapping controlled group of entities, but not one single controlled group of entities, the unitary business group shall be that controlled group of entities that satisfies the relationship test under MCL 208.1117. If more than one controlled group of entities satisfies the relationship test, the members shall elect the controlled group of entities that will file as a unitary business group. This election shall remain in effect until the unitary relationship between the entity and its elected controlled group is discontinued, or until revoked with the approval of the Department.

Example 10. Individual A owns a 75% capital interest in Partnerships X and Y, and 50% of the stock in Corporations L and M. The remaining 50% of L and M are owned by individuals B and C respectively. Individuals A, B, and C are unrelated. Under this RAB (including the indirect ownership principles discussed in Section VII), X, Y, and L comprise a brother-sister controlled group of entities. X, Y, and M also comprise a brother-sister controlled group of entities. However, X, Y, M, and L do not comprise a single controlled group of entities (since either L or M is the indirect owner of X and Y, but neither L nor M owns the other). The unitary business group in this case will be that controlled group of entities that satisfies the relationship test. If both controlled groups of entities satisfy the relationship test, then the members must elect one of such controlled groups of entities to file as a unitary business group.

VII. INDIRECT OWNERSHIP

Under MCL 208.1117, ownership and control includes indirect ownership and control. Indirect ownership includes ownership through attribution. Except as noted below, an ownership interest is indirectly owned by a person when that person constructively owns such an interest.

(A) Family. An individual constructively owns the ownership interests owned, directly or indirectly, by any of the following:

- (1) His or her spouse (other than a spouse who is legally separated from the individual under a decree of divorce or a decree of separate maintenance).
- (2) His or her children (including legally adopted children), grandchildren, and parents.

Example 11. Brother owns 100% of Corporation B. Brother's sibling, Sister, owns 100% of Corporation S. Brother and Sister's parents are both living. Under (A)(2), Father or Mother own 100% of both Corporation B and Corporation S. Furthermore, under (C)(2), Corporation B indirectly owns 100% of Corporation S, and *vice versa*. Corporation B and Corporation S constitute a brother-sister controlled group of entities and meet the control test for unitary business groups.

(B) Attribution from Partnerships, Corporations, and Trusts and Estates.

(1) **Partnerships.** Ownership interests owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5% or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever is greater.

(2) **Corporations.** If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the ownership interests owned, directly or indirectly, by or for such corporation, in that proportion to which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(3) **Trusts and Estates.**

(a) Ownership interests owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5% or more in such ownership interests, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such ownership interests to satisfy his rights as a beneficiary.

(b) Ownership interests owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E⁵ of part I of subchapter J of the IRC (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(c) This paragraph shall not apply to ownership interests owned by any employees' trust described in IRC 401(a) that is exempt from federal income tax under IRC 501(a).

(C) Attribution to Partnerships, Corporations, and Trusts and Estates.

(1) **Partnerships.** Ownership interests owned, directly or indirectly, by or for a partner shall be considered as owned by the partnership.

(2) **Corporations.** If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the ownership interests owned, directly or indirectly, by or for such person.

(3) **Trusts and Estates.**

(a) Ownership interests owned, directly or indirectly, by or for a beneficiary of an estate shall be considered as owned by the estate.

(b) Ownership interests owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in IRC 401(a) and exempt from federal income tax under IRC 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this subsection, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5% or less of the value of the trust property.

(c) Ownership interests owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E⁶ of part I of subchapter J of the IRC (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(D) Options. If any person has an option to acquire any ownership interest in an organization, such interest shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such interest.

⁵ Generally, IRC 671-679.

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(E) Operating Principle.

(1) **In General.** Except as provided in subparagraphs (2) and (3) below, ownership interests constructively owned by a person by reason of the application of paragraphs (A), (B), (C), or (D) above, shall, for purposes of applying paragraphs (A), (B), (C), or (D), be considered as actually owned by such person.

(2) **Members of Family.** Ownership interests constructively owned by an individual by reason of the application of paragraph (A) shall not be considered as owned by him for purposes of again applying paragraph (A) in order to make another the constructive owner of such ownership interests.

(3) **Partnerships, Corporations, and Trusts and Estates.** Ownership interests constructively owned by a partnership, corporation, estate, or trust by reason of the application of paragraph (C) shall not be considered as owned by it for purposes of applying paragraph (B) in order to make another the constructive owner of such ownership interests.

(4) **Precedence of Option Principle.** For purposes of this paragraph, if an ownership interest may be considered as owned by a person under paragraph (A) or (D), it shall be considered as owned under paragraph (D).

(5) **Ownership by 2 or More Persons.** If an ownership interest is owned by two or more persons, such an interest shall be considered as owned by the person whose ownership of such an interest results in the entity being a member of a controlled group of entities. If by reason of the preceding sentence, an entity would (but for this sentence) become a member of two controlled groups, it shall be treated as a member of one controlled group.

(6) **S Corporations.** For purposes of this Section VII, an S Corporation shall be treated as a partnership and any shareholder of the S Corporation shall be treated as a partner of such partnership.