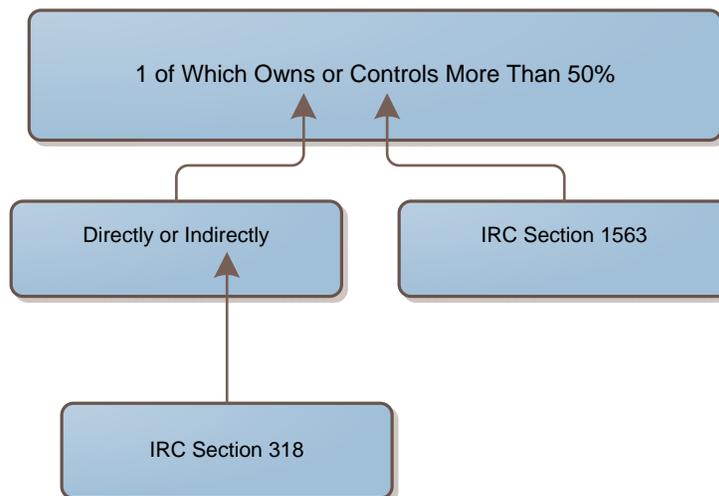


The Control Test for a Brother-Sister Group of Entities A Michigan Business Tax Unitary Business Group Must Pass Both The Control Test and the Relationship Test

The one question that comes up most often at MACPA seminars and conferences is how *The Control Test for a Michigan Business Tax Unitary Business Group* is applied to a brother-sister group of entities. The purpose of this white paper is to completely discuss the statutory provisions that authorize “unitary” as well as the attribution rules which are used to determine indirect ownership. Numerous examples are provided with organizational charts to aid in the understanding of this extremely complicated topic.

Authorization for unitary is found in Section 511 of the Michigan Business Tax Act (MBTA). “A unitary business group must file a combined return ...” [MCL 208.1511] The term “unitary business group” is defined in MBTA Section 117(6). The plain wording of Section 117(6) [MCL 208.1117(6)] says, “Unitary business group” means 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 . . . [MCL 208.1117(6)] (Emphasis added) The two words highlighted in the above statutory quote, controls and indirectly, are troublesome and they beg for more definition.



Controls: Treasury has stated they will look to IRC Section 1563 for clarification of “controls.” In Section 1563, the IRC defines “controls” in the context of the term “controlled group of corporations” for purposes of meeting the 80% or more ownership requirement for consolidated return filing. Treasury has incorporated IRC Section 1563, but has changed the IRC requirement of 80% or more to the MBTA Section 117(6) requirement of “more than 50%” and applies it to all forms of ownership, such as partnership and membership interests, and not just corporate stock.

Indirectly: Treasury has interpreted the legislative use of the term “indirectly” to be consistent with the use of the tax term “constructive ownership” and thereby has employed the attribution rules of Internal Revenue Code (IRC) Section 318 to define “indirect” ownership. Treasury has provided guidance on how the *control test* for a “unitary business group” will be applied. Such guidance is found in Treasury FAQ U34.

Generally, a “unitary business group” is a group of related persons whose business activities or operations are interdependent. More specifically, a “unitary business group” is two or more persons that satisfy both a *control test* and one of two *relationship tests*. [MCL 208.1117(6)] A unitary business group is a single taxpayer under the MBT and must file a combined return. [MCL 208.1117(5) and MCL 208.1511] Foreign persons and foreign operating entities cannot be part of a “unitary business group.” [Treasury FAQ U34]

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

The specifics of the statute read as follows:

“Unitary business group” means 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 [MCL 208.1117.]

A person owns or controls more than 50% of the ownership interest with voting rights or ownership interest that confer comparable rights to voting rights of another persons if that person owns (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.

Indirect ownership is generally determined using IRC 318 or analogous authority, except that the Department will apply IRC 318 to all forms of ownership interests, such as partnership and membership interests, and not just corporate stock.

Example: Attribution to and from a partnership may be determined under IRC 318(a)(2)(A) and 318(a)(3)(A). However, the attribution will be of ownership interests, including but not limited to partnership interests, stock, and membership interests; attribution will not be limited to corporate stock. [Treasury FAQ U34]

Brother-Sister Controlled Group of Entities

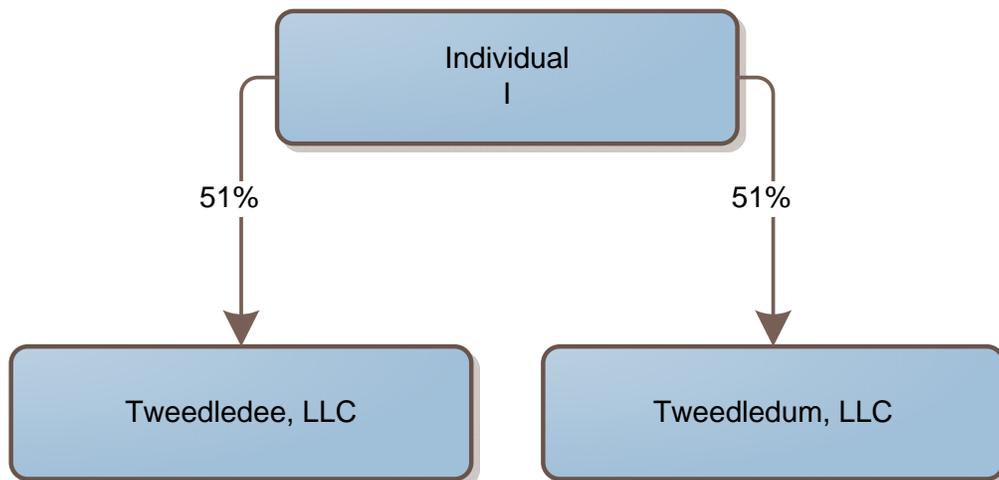
A brother-sister group of entities may also satisfy the control test. However, the final determination is based on a variety of factors, including the type of entity. An individual that is not a sole proprietor or owner of a disregarded entity or otherwise engaged in a trade or business resulting in business income or gross receipts under the MBT is not unitary with the entities in which that individual has a controlling interest. However, a brother-sister group of entities may satisfy the control test through the indirect ownership rules of IRC 318 - this is referred to as a brother-sister controlled group of entities. [Treasury FAQ U34] See Treasury FAQ U25 below.

U25. Can brother-sister corporations wholly owned by a single person be members of a unitary business group? If so, how are the tax bases calculated?

Yes. To qualify as a unitary business group under the MBT, a group must satisfy the control test and one of two relationship tests: business activities or operations that (1) result in a flow of value between members or that (2) are integrated with, dependent upon, or contribute to each other. [MCL 208.1117]

In the case of a brother-sister set of corporations wholly owned by a person, the corporations will satisfy the control test under MCL 208.1117. That is, the brother corporation – under IRC 318 – is the indirect owner of more than 50% of the ownership interests of the sister corporation and vice versa. However, the brother-sister corporations will not comprise a unitary business group unless the corporations also satisfy one of the two relationship tests.

Example 1: An individual owns 51% each of a pair of limited liability companies taxed as partnerships, Tweedledee LLC and Tweedledum LLC.

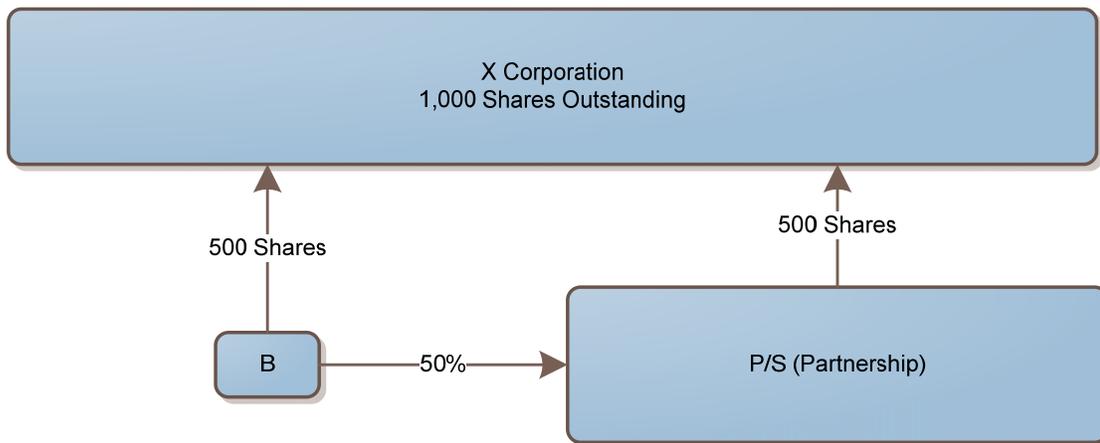


Under IRC 318(a)(3)(A), as applied to the MBT, Tweedledee LLC owns 51% of Tweedledum LLC. Tweedledee LLC and Tweedledum LLC constitute a brother-sister controlled group of entities and meet the control test for unitary business groups. [Treasury FAQ U34]

Attribution from Partner to Partnership

Stock owned directly or indirectly by a partner is considered as owned by the partnership. [Section 318(a)(3)(A)] All of the stock of the partner is deemed to be owned by the partnership regardless of the size of the partner's interest.

Example 2: B, an individual, owns a 50% interest in a partnership. B owns 500 of the 1,000 outstanding shares of X Corporation and the partnership owns the other 500 shares.



X Corporation and P/S Partnership do not satisfy the control test for a unitary business group based on direct ownership.

However, by application of IRC Section 318(a)(3)(A), the partnership is deemed to own B's 500 shares of X Corporation in addition to the 500 shares it actually owns.

Therefore, P/S Partnership owns directly and indirectly all of the outstanding shares in X Corporation and thereby satisfies the control test for a unitary business group.

There is no attribution of stock held by one partner to another. A partner in a partnership is not deemed to own the stock of his or her partner. In addition, under Section 318(a)(5)(C), stock ownership attributed from a partner to a partnership may not be re-attributed to another partner. See Treasury FAQ U39 below.

U39. Are partners deemed to own each others' holdings by attribution under Section 318 of the Internal Revenue Code?

No. Section 318 of the Internal Revenue Code ("IRC") establishes the attribution rules for constructive ownership of stock for federal income tax purposes. IRC Sections 318(a)(2) and 318(a)(3) address the attribution rules for partners and partnerships. Under IRC §318(a)(2), stock owned, directly or indirectly, by or for a partnership is considered as owned proportionately by its partners. Conversely, under IRC §318(a)(3), stock owned, directly or indirectly, by or for a partner is considered as owned by the partnership.

However, under IRC §318(a)(5)(C), a partnership that constructively owns a partner's stock by application of the attribution rules as stated in IRC §318(a)(3) cannot use the attribution provisions of IRC §318(a)(2) to make another partner the constructive owner of such stock. For example, if partner A owns 100% of the stock in corporation C, and partner B owns 100% of the stock in corporation D, the partners are not deemed to own each other's stock merely because partnership AB is considered a constructive owner of all stock in both corporations by attribution under IRC §318(a)(3).

The Department makes use of the IRC §318 attribution rules to determine if a group of persons meets the ownership or control tests necessary to form a unitary business group under section 117 of the MBT act (MCL 208.1117). In the example given above, corporations C and D and partnership AB could be part of the same unitary group because more than 50% of the ownership interest in each corporation is deemed to be owned or controlled by the same person, partnership AB, through attribution under IRC §318. However, IRC §318(5)(d) would operate to prevent corporations C and D from being considered brother-sister corporations (because partners A and B are not deemed to own each others stock), and therefore corporations C and D alone could not constitute a unitary business group for MBT.

S Corporation Treated as a Partnership

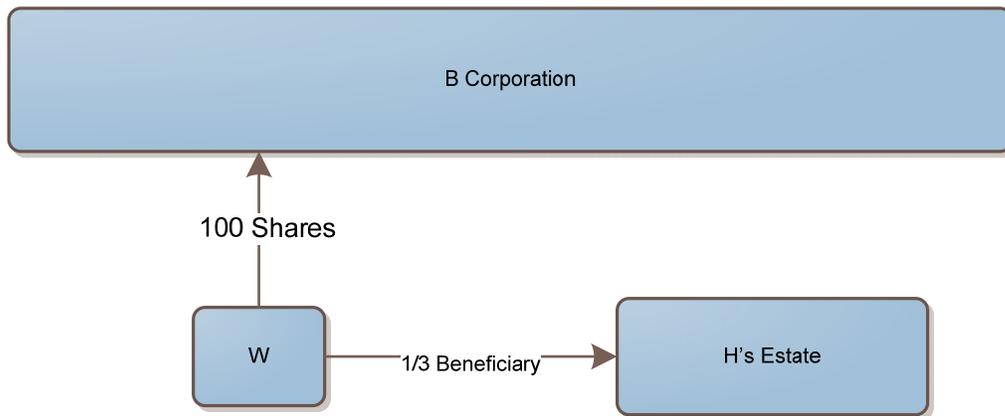
An S corporation and its shareholders are treated as a partnership and partners, respectively, for purposes of the attribution rules. [Section 318(a)(5)(E)]

Stock held by the S corporation is deemed to be owned by its shareholders proportionately and stock held by the shareholders is deemed to be owned by the S corporation.

Attribution from Beneficiary to Estate

All stock owned directly or indirectly by a beneficiary is deemed to be owned by the estate. [Section 318(a)(3)(A)] Unlike the proportionate attribution of stock from an estate to beneficiaries, the entire stockholding of a beneficiary is deemed constructively owned by the estate. [*Lewis v. Commissioner*, 35 T.C. 71 (1960); Revenue Ruling 56-103, 1956-1 C.B. 159]

Example 3: B Corporation has 100 shares outstanding, which are owned by W. H dies leaving one-third of his property to W.

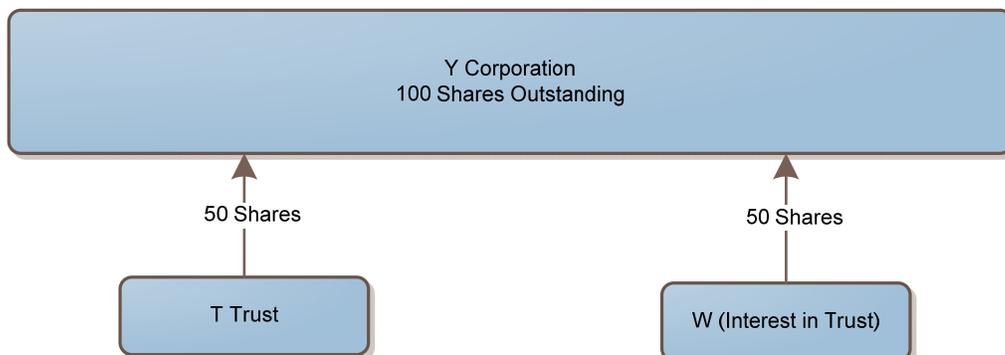


Since W is a beneficiary of H's estate, the estate is deemed to own all of W's 100 shares in B Corporation.

Attribution from Beneficiary to Trust

All of the stock owned directly or indirectly by a beneficiary of a trust is considered owned by the trust, unless the beneficiary's interest in the trust is a remote contingent interest. [Section 318(a)(3)(b)]

Example 4: T Trust owns 50 of the outstanding shares of Y Corporation. W, who has an interest in T Trust which is not a remote contingent interest, owns the other 50 shares.

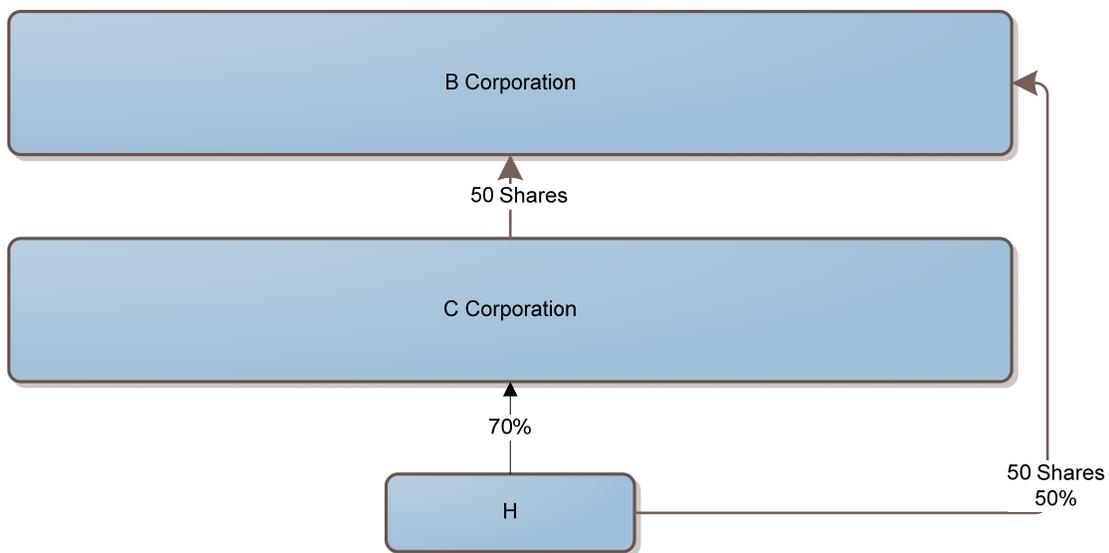


T Trust is deemed to own the 50 shares owned by W, plus the 50 shares it actually owns. Consequently, T Trust is deemed to own all of the outstanding shares of Y Corporation.

Attribution from Shareholder to Corporation

If a shareholder owns directly or indirectly 50% or more of the value of the stock of a corporation, that corporation is deemed to own all, not just a proportionate amount, of the stock held by the shareholder. [Section 318(a)(3)(C)]

Example 5: H owns 70% of the value of the stock of C Corporation. C Corporation owns 50 of the 100 outstanding shares of B Corporation. H owns the balance of the stock of B Corporation.



Based on direct stock ownership, B Corporation and C Corporation do not satisfy the control test requirement for a unitary business group because the C Corporation ownership in B Corporation is only 50%, not more than 50%.

Because H owns more than 50% of the value of the stock of C Corporation, C Corporation is deemed to own all of H's 50 shares in B Corporation.

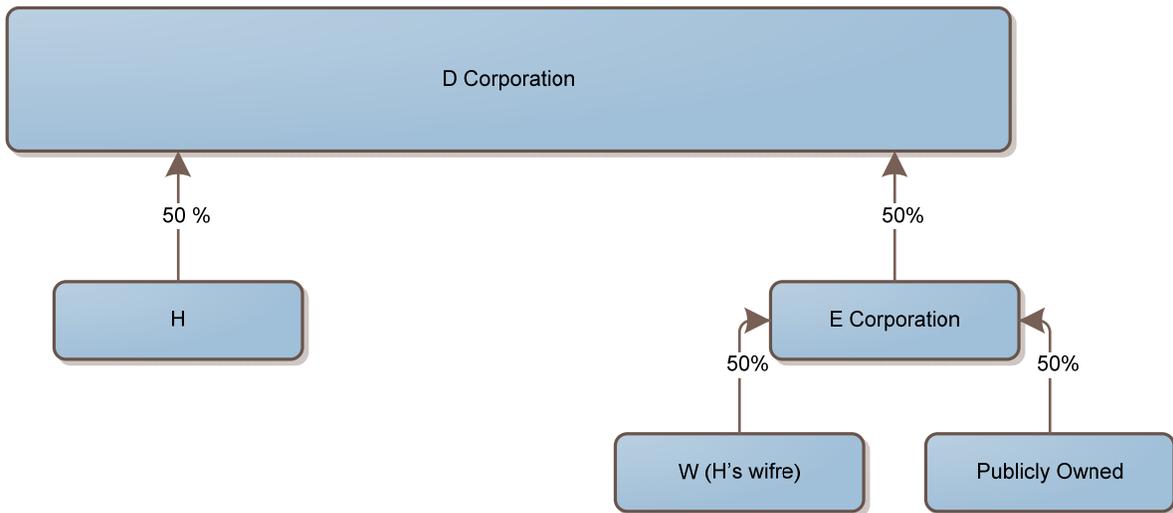
C Corporation is then deemed to own all of the shares of B Corporation: 50 shares actually owned and 50 shares held by H which C Corporation is deemed to own.

In addition, B Corporation is deemed to own all of H's stock in C Corporation if H's stock ownership in B Corporation represents 50% of the value of the stock.

After application of IRC Section 318(a)(3)(c), B Corporation and C Corporation satisfy the control test for a unitary business group.

For purposes of the shareholder-to-corporation attribution rules, actual and constructive ownership determines whether the 50%-of-value benchmark is reached. [Income Tax Regulation Section 1.318-1(b)(3)]

Example 6: H owns 50% of D Corporation. E Corporation owns the balance of the shares in D Corporation. H's wife, W, owns 50% of the value of the stock of E Corporation. The balance of the E Corporation stock is publicly held.



Based on direct stock ownership, D Corporation and E Corporation do not satisfy the control test requirement for a unitary business group because E Corporation fails the more than 50% ownership requirement in D Corporation.

Because H's shares in D Corporation are attributed to W under the family attribution rules of Section 318(a)(1)(A)(i), she is deemed to own 50% of D Corporation.

E Corporation is deemed to own the stock actually and constructively owned by W because she owns 50% of the value of the stock.

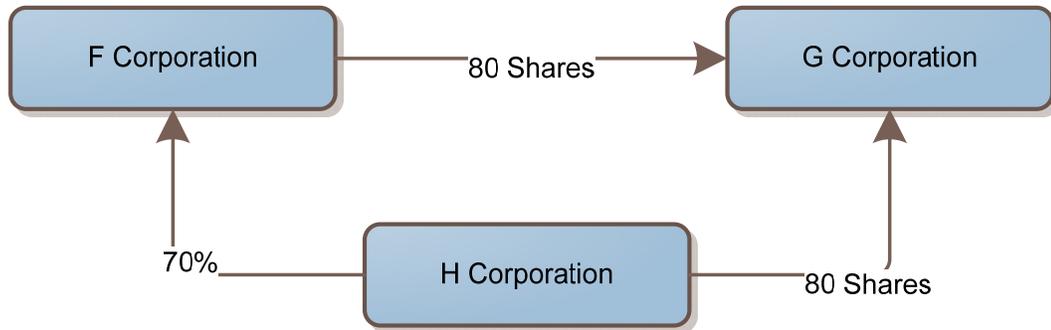
Therefore, E Corporation is deemed to constructively own the other 50% of the stock in D Corporation.

The stock of D Corporation constructively owned by W is attributed to E Corporation even though W has no actual ownership in D Corporation.

Therefore, after application of the attribution rules in IRC Section 318(a)(1)(A)(i), family member attribution, and IRC Section 318(a)(3)(c), shareholder to corporation attribution, D Corporation and E Corporation satisfy the control test requirement for a unitary business group because after attribution, E Corporation owns directly and indirectly 100% of the stock in D Corporation.

A corporation is never considered to own its own stock under Section 318(a)(3)(C). [Income Tax Regulations Section 1.318-1(b)(1)]

Example 7: H Corporation owns 70% of the value of the outstanding shares of F Corporation. H Corporation also owns 80 shares of G Corporation stock with F Corporation owning the other 80 shares.



Based on direct ownership, H Corporation and F Corporation satisfy the control test for a unitary business group, more than 50%. However, G Corporation does not satisfy the control test for a unitary business with respect to either H Corporation or F Corporation because their ownership in G Corporation is not more than 50%.

Because H Corporation owns at least 50% of the value of the stock of F Corporation, F Corporation is deemed to own H Corporation's 80 shares in G Corporation in addition to the 80 shares owned directly.

F Corporation is not deemed to own any of its own 70 shares.

After application of IRC Section 318(a)(3)(c), shareholder to corporation attribution, F Corporation owns 100% of G Corporation. F Corporation, G Corporation, and H Corporation satisfy the control test for a unitary business group.

Guidance from Treasury

The following FAQ is provided, not because it necessarily provides the right answer, but because it shows the importance of the Section 318 attribution rules in coming to an answer. On the surface the answer is NO. However, after application of the Section 318 attribution rules, the answer becomes YES.

FAQ U6: Would a group of companies who have a flow of value between them but are owned by two nonrelated persons, each owning 50%, be considered a unitary business group?

No. To meet the definition of a unitary business group in the Michigan Business Tax Act (MBTA) the U.S. persons, other than foreign operating entities, which cannot be included in the group, must pass a control test and 1 of 2 relationship tests. [MCL 208.1117(6)] 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. [MCL 208.1117(6)]

For purposes of MBTA section 117(6), the Department will use as guidance attribution rules expressed in IRC §318 or analogous authority to determine indirect or constructive ownership and control. While IRC §318 specifically pertains to corporate stock ownership, the Department will apply its principles to all forms of entities subject to the MBT.

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.

The answer to this FAQ, as described in the third paragraph, is **wrong** because it does not consider application of the Section 318 attribution rules referenced in the second paragraph. The FAQ doesn't state the type of entity; however, the type of entity is not relevant because the two unrelated owners each own 50% of the brother-sister entities.

Section 318(a)(3)(A) provides that stock owned by a partner of a partnership is deemed to be owned by the partnership.

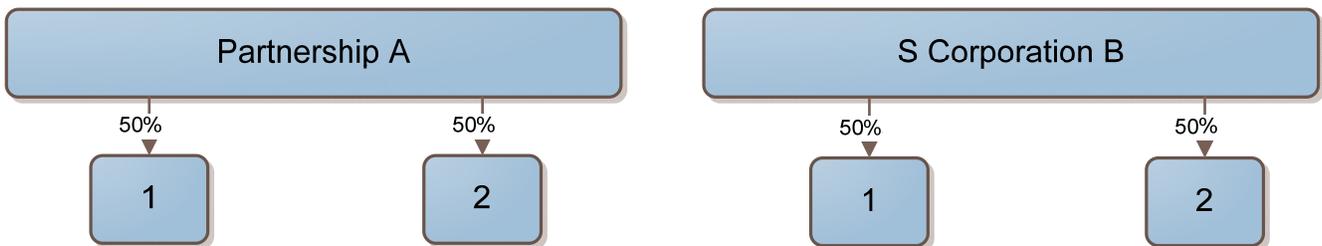
Section 318(a)(3)(A) also provides that stock owned by a beneficiary of an estate is deemed to be owned by the estate.

Section 318(a)(3)(B) provides that stock owned by a beneficiary of a trust is deemed to be owned by the trust.

Section 318(a)(3)(C) provides that stock owned by a 50% or more in value shareholder is deemed to be owned by the corporation.

In FAQ U6, it is immaterial what types of entities are involved. Whether the commonly owned entities are partnerships, estates, trusts or corporations, the entity is deemed to own the stock or other type of ownership interest owned by the partner, beneficiary or shareholder, thus satisfying the MBTA Section 117(6) "1 of which owns ... more than 50%" requirement.

Example 8: Partnership A is owned by Individual 1 (50%) and Individual 2 (50%). Individual 1 and Individual 2, who are brothers, also own 50% each of the stock in S Corporation B. There is a flow in value between Partnership A and S Corporation B. Do they meet the control test and thereby file a combined MBT return?



YES, Partnership A and S Corporation B do meet the control test and are required to file a combined MBT return. Although there is no attribution between brothers, IRC Section 318(a)(3)(A) provides that "Stock owned directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate."

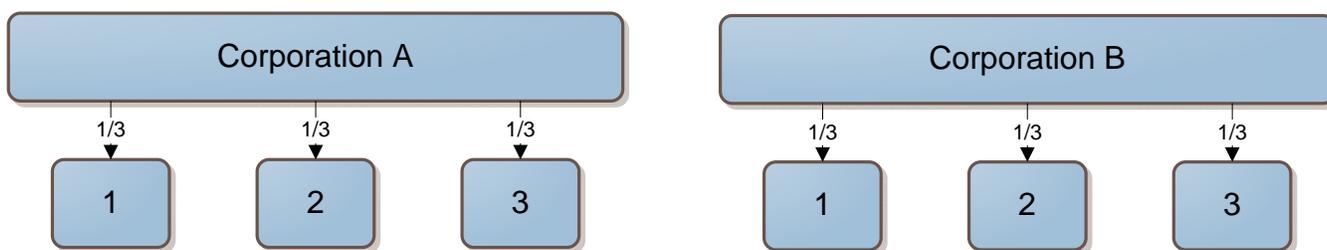
Therefore, Partnership A is deemed to own the stock in S Corporation B owned by Individual 1 and Individual 2. The control test is satisfied because Partnership A owns directly or indirectly more than 50% of the stock in S Corporation B.

The converse is true for S Corporation B because IRC Section 318(a)(5)(E)(i) states "an S corporation shall be treated as a partnership." Therefore, S Corporation B is deemed to own the partnership interest in Partnership A owned by Individual 1 and Individual 2. The control test is satisfied because S Corporation B owns directly or indirectly more than 50% of the stock in Partnership A.

IRC Section 318 pertains only to the ownership of stock in a corporation. However, the Michigan Department of Treasury, in using IRC Section 318 for determining indirect ownership is applying such provisions to all forms of ownership. In Treasury FAQ U34, Treasury stated: "Indirect ownership is generally determined using IRC 318 or analogous authority, except that the Department will apply IRC 318 to all forms of ownership interests, such as partnership and membership interests, and not just corporate stock.

For example, attribution to and from a partnership may be determined under IRC 318(a)(2)(A) and 318(a)(3)(A). However, the attribution will be of ownership interests, including – but not limited to – partnership interests, stock, and membership interests; attribution will not be limited to corporate stock.” [Treasury FAQ U34]

Example 9: Corporation A is owned by 1/3 each by individuals 1, 2 and 3. The same three individuals who are cousins, also own 1/3 each of the stock in Corporation B. There is a flow in value between Corporation A and Corporation B. Do they meet the control test and thereby file a combined MBT return?



NO, even though there is a flow of value between Corporation A and Corporation B and they satisfy the relationship test, they are not members of a “unitary business group” because they fail the control test and Section 117(6) [MCL 208.117(6)] specifies that both tests must be met.

Although individuals 1, 2 and 3 are related (cousins), the IRC Section 318(a)(1)(A) family member attribution rules do not extend to cousins.

Furthermore, the IRC Section 318(a)(3)(C) attribution from shareholders to a corporation is not applicable because the “50% or more” threshold test is not met. Therefore, the control test requirement of “more than 50%” ownership or control has not been satisfied.

If in Example 9, the ownership was shared by two individuals, 50% each, as was the case in Example 8, then the control test would be satisfied because the “50% or more” threshold test would have been met allowing for the IRC Section 318(a)(3)(C) attribution from shareholders to the corporation.

IRC Section 318(a)(3)(C) applies only to C Corporations.

Tax Planning Opportunities

The statutory requirements for a “unitary business group” and specifically the attribution rules for the control test direct or indirect requirement are very complicated. The attribution rules vary by type of entity and level of relationship. The complexity of the

rules provides an opportunity for proactive tax planning. Depending on the desired outcome, proactive tax planning can achieve either the inclusion or exclusion of an entity or entities in a “unitary business group.”