

# Income Tax Newsletter

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## Impact Of The Michigan Business Tax On Real Estate Operations

By Jeffrey D. Moss

Although the Michigan Business Tax (“MBT”) became effective January 1, 2008, the Michigan Treasury issued the draft forms and instructions for this tax on November 5, 2008. We have considered the impact of this tax on our clients since its enactment. The following is an interim update. The MBT has two primary components: (i) A modified gross receipts tax imposed at 0.8%; and (ii) a business income tax imposed at 4.95%. These are not alternative taxes. Most companies will be subject to and must pay both components of the tax. In addition, some businesses are subject to the surcharge of 21.99% of the combined tax amount before allowable tax credits. The surcharge may be the topic of a future newsletter.

A “business activity” under the MBT includes the rental of real property, thus making rental income subject to the tax. MCL 208.1105(1). Rental income received from real property located in Michigan is included in both the modified gross receipts tax base and the business income from business activity tax base.

There are some exclusions from the definition of “gross receipts” which are applicable to real estate operations. If a sale of property occurs and the property is a non-depreciable capital asset under IRC § 1221(a), or it is land that qualifies as property used in a trade or business as defined under IRC § 1231(b), only the net gain is included in gross receipts and the return of basis is excluded from gross receipts. MCL 208.1111(1)(o). Other important exclusions from gross receipts are funds received purely in an agency or management capacity. For example, a management company, which receives rent and passes the rent entirely to the landlord, may exclude these rental receipts. In addition, real property managers who receive funds placed in a segregated property maintenance account may exclude those funds from gross receipts. MCL 208.1111(1)(e). Thus, it becomes more important for property owners and management companies to keep more accurate records of security deposits and escrow payments and to segregate CAM expenses from rental payments. The MBT will likely cause owners to favor triple net leases over gross leases because the gross lease does not separate these excludable items and the property owner will pay tax on that portion of the income.

Also, the value of real property received in a like-kind exchange under Section 1031 of the Internal Revenue Code is excluded from gross receipts. However, if as part of the exchange, other property or money is received and gain is recognized due to the distribution of “boot” for federal income tax purposes, that gain will be included in gross receipts for MBT purposes.

Another example of a new taxable event under the MBT is the short sale. If a real estate entity sells its property for less than its debt, (e.g. to avoid outright foreclosure), and the entity obtains debt forgiveness from its lender, both the capital gain and cancellation of indebtedness income that are passed through to the owners will be subject to MBT at the entity level, although the entity itself does not pay federal tax. (See MBT Q & A B22.) Previously, under the now repealed SBT, there was an exception for isolated transactions and there was an argument that a deed in lieu of foreclosure was exempted as an isolated transaction. Fortunately, the MBT does continue the prior credits and incentives from the SBT, including MEGA credits, Historic Preservation credits, Brownfield Rehabilitation credits and Renaissance Zone credits.

This newsletter is not meant to be entirely encompassing. Please direct more specific questions to me or any other member of the Butzel Long Income Tax Group.