Legislative Analysis

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CIT FLOW-THROUGH ENTITY WITHHOLDING: HOUSING DEVELOPMENT ENTITIES

Senate Bill 473 without amendment ***(Enacted as Public Act 295 of 2014)***
Sponsor: Sen. Jack Brandenburg
House Committee: Tax Policy
Senate Committee: Finance

Complete to 5-13-14

A SUMMARY OF SENATE BILL 473 AS PASSED BY THE SENATE 10-8-13

Part 3 of the Income Tax Act (MCL 206.703) requires flow-through entities with business activity in Michigan that have more than $200,000 of business income in the tax year, after allocation or apportionment, to withhold a tax on the distributive share of business income of each corporation or flow-through member of the flow-through entity. (Generally, the term "flow-through entities" refers to S-corporations, partnerships, limited partnerships, limited liability partnerships, or limited liability companies.)

Senate Bill 473 provides that flow-through entities would not be required to comply with the withholding requirements if the withholding would violate any of the following:

- Housing and Urban Development housing assistance payment programs distribution restrictions under Title 24, Parts 880,881,883, or 891 of the Code of Federal Regulations.
- Rural Housing Service return on investment restrictions under 7 CFR 3560.68 or 7 CFR 3560.305.
- Articles of incorporation or other documents of organization adopted under Section 83 (limited dividend housing corporation) or Section 93 (limited dividend housing association) of the State Housing Development Authority Act.

FISCAL IMPACT:

As written, the bill would have no impact on state or local revenues. The language does not exempt taxes in these instances, it simply allows for compliance with specific programs in regards to withholding.

BACKGROUND INFORMATION:

Under the State Housing Development Authority Act (1966 PA 346), the Michigan State Housing Development Authority (MSHDA) provides mortgage loans to a variety of entities, including developers, to construct and rehabilitate multi-family housing projects. To obtain financing from MSHDA, developers typically form a "limited dividend housing association," which functions as the borrowing entity. The association and MSHDA enter into a "regulatory agreement" that typically regulates such things as rental rates and tenant eligibility, and requires a portion of rental units in the housing project to be rented to individuals with low or moderate incomes. In exchange for these restrictions, the association receives below-market interest rates, rent subsidies, and other tax benefits. [There are similar programs within the U.S. Department of Housing and Urban Development and the U.S. Department of Agriculture.]

Under PA 346, limited dividend housing associations include general or limited partnerships and limited liability companies, which in the tax laws are types of "flow-through entities" where income gains, losses, deductions, and credits are not taxed to the entity itself, but rather "flow-through" to the individual partner's or member's tax return.

The act generally requires that the association's operating agreement (LLC's) or partnership agreement (LP's) or other document of basic organization provide that individual partners or members agree to restrict the amount of return on their investment to the face value of the investment, based on their respective interest, plus cumulative dividend payments limited to a rate (e.g., 6%) set by MSHDA and agreed to by the association in a regulatory agreement. Under the terms of a regulatory agreement, the association may make distributions to partners or members only from surplus cash, i.e. the remaining available cash after all necessary and reasonable expenses have been paid.

The Income Tax Act's withholding requirements raise two issues relative to limited dividend housing associations, and similar types of housing entities:

1. Many associations do not have surplus cash available to make withholding payments, meaning that tax withholding payments (often due even where there is no cash distribution) would have to come from operating funds or another fund source.

2. Because the withholding payment is made for the benefit of the partner or member (paying their tax obligation or refunded when it exceeds the tax obligation), it would be considered a distribution, which under the terms of the regulatory agreement could only be made from surplus cash. However, since that payment would not be made from surplus cash, it would not be made in compliance with the regulatory agreement.

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