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INCOME TAX WITHHOLDING FOR FLOW-THROUGH ENTITIES, ETC.

**House Bills 4558 and 4559 as enrolled
Public Acts 51 and 50 of 2003
Sponsor: Rep. Paul Condino**

**House Bills 4560 and 4562 as enrolled
Public Acts 49 and 48 of 2003
Sponsor: Rep. Paula K. Zelenko**

**House Bill 4561 as enrolled
Public Act 22 of 2003
Sponsor: Rep. William J. O'Neil**

**House Bills 4563 and 4565 as enrolled
Public Acts 47 and 45 of 2003
Sponsor: Rep. Barbara Farrah**

**House Bill 4564 as enrolled
Public Act 46 of 2003
Sponsor: Rep. Jack Minore**

**House Committee: Tax Policy
Senate Committee: Finance**

Second Analysis (7-21-03)

THE APPARENT PROBLEM:

The Department of Treasury says that while nonresidents who receive distributions from flow-through entities, such as partnerships and limited liability companies, are subject to Michigan income taxes, a significant number do not pay the required tax. The department has proposed a two-pronged solution that would require flow-through entities to withhold taxes and would encourage flow-through entities to file a composite state income tax return (rather than separate returns for each member of the entity). In a related matter, legislation that has already passed the House of Representatives would tax the casino and race track winnings of nonresidents. Companion legislation is needed to authorize the withholding of these winnings and to otherwise include casino and race track winnings in the collection and administration provisions of the Income Tax Act.

THE CONTENT OF THE BILL:

House Bill 4561 would amend the Income Tax Act (MCL 206.351) to extend the withholding requirements that are currently imposed on employers so that they would apply to 1) distributions made by flow-through entities to nonresident members; 2) winnings of nonresidents reportable under federal tax law by casinos licensed under the Michigan Gaming Control and Revenue Act; and 3) winnings of nonresidents reportable under federal tax law by race meeting licensees and track licensees operating under the Horse Racing Law of 1995. The bill would take effect October 1, 2003.

[Note: With regard to flow-through entities, generally speaking, any income, gain, loss, deduction, or credit is not taxed to the entity itself, but rather “flows through” to the individual partner’s or member’s tax return. Flow-through entities include S corporations, partnerships, limited liability partnerships, and

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limited liability companies. The term is defined for the purposes of this package in House Bill 4565, described later. The Michigan Gaming Control and Revenue Act does not, generally speaking, apply to gaming conducted in the state under the federal Indian Gaming Regulatory Act.]

The other bills in the package were all tie-barred to House Bill 4561, meaning that they were only to take effect if House Bill 4561 took effect, and each bill would amend a separate section of the Income Tax Act essentially to implement the withholding requirements of House Bill 4561. Each bill would have an effective date of October 1, 2003.

Under the Income Tax Act, employers are required to withhold a tax on the compensation of an individual in an amount equal to the product of the rate set forth in Section 51 of the act (4 percent for the 2003 tax year, 3.9 percent for the 2004 tax year and subsequent years) and the compensation (less an amount for any personal and dependency exemptions).

House Bill 4561 would amend the act to require flow-through entities to withhold a tax in an amount based on the same method for employers, as stated above. If the flow-through entity is a nonresident member of a separate flow-through entity in this state, the entity in this state would withhold the tax on behalf of the nonresident flow-through entity and all nonresident members of the nonresident flow-through entity.

In addition, every casino licensee licensed under the Michigan Gaming Control and Revenue Act would be required to withhold a tax in an amount equal to the product of the rate set in section 51 and the winnings of a nonresident reportable by a casino licensee in accordance with the federal Internal Revenue Code. In addition, every race meeting licensee or track licensee licensed under the Horse Racing Law of 1995 would be required to withhold a tax in an amount equal to the product of the rate set in section 51 and the payoff price on a winning ticket of a nonresident reportable under the Internal Revenue Code. Further, every casino licensee and track/race meeting licensee would be required to report to the Department of Treasury the reportable winnings of a resident in the manner provided in the Internal Revenue Code. The bill would also delete a provision pertaining to the failure of a corporation to pay the tax or file a return. That provision, however, is substantially similar to a provision in the revenue act [MCL 205.27A(5)] that would be amended by House Bill 4567.

Finally the bill would extend other requirements for employers when withholding a tax to the flow-through entities, casinos, and race meeting/track licensees. More specifically, the flow-through entity, casino, or race meeting/track licensee would be required to pay the tax within 15 days of the end of the month; hold the amount as a trustee for the state, and be liable for the payment to the state (though not liable to any individual); and provide copies of any exemption certificates whereby a nonresident member or individual subject to the casino or race meeting withholding claims more than nine personal or dependency exemptions, claims a status that exempts that individual, or elects to pay the tax.

House Bill 4558 would amend the definition of “tax” under the Income Tax Act (MCL 206.22) so that “tax” would include any taxes required to be withheld by a flow-through entity on nonresident members’ share of income available for distribution.

House Bill 4559 would amend the definition of “taxpayer” under the Income Tax Act (MCL 206.26) to include any flow-through entity required to withhold taxes on a nonresident member’s share of income available for distribution.

House Bill 4560 would amend the Income Tax Act (MCL 206.315) to permit a nonresident member who has income in the state from a flow-through entity to elect to be included in the composite income tax return of a flow-through entity of which the nonresident member is a member. Similarly, the bill would permit a flow-through entity to file a composite income tax return on behalf of electing nonresident members and report and pay the tax due based on the electing nonmembers’ shares of income available for distribution from the flow-through entity for doing business in, or deriving income from, sources within the state. Further, a nonresident member that has been included in a composite tax return and that files an individual income tax return for the same taxable period would be permitted to claim a credit on the individual income tax return for the amount of taxes paid on behalf of the nonresident member by the flow-through entity on the composite return. A composite income tax return would be due on or before April 15th of each year and include information required by the department for the immediately preceding calendar year.

House Bill 4562 would amend the Income Tax Act (MCL 206.355) to extend all provisions pertaining to the administration, collection, and enforcement of the act to flow-through entities, casino licensees under the Michigan Gaming Control and Revenue Act, and

race meeting/track licensees licensed under the Horse Racing Law of 1995 required to withhold taxes. Further, the bill would add that if the Department of Treasury has reason to believe that a flow-through entity, casino licensee, or race meeting/track licensee will not pay taxes withheld, or in order to provide a more efficient administration, the department could require the flow-through entity, casino licensee, or race meeting/track licensee to make the return and pay the taxes withheld at other than monthly periods, or require the flow-through entity, casino licensee, or race meeting/track licensee to deposit the tax in an approved bank, in trust and payable to the department. [Note: the provisions described above currently apply to an employer. This bill would extend those provisions to flow-through entities, casino licensees, and race meeting/track licensees.]

In addition, the bill would add that every publicly traded partnership (defined under the Internal Revenue Code) that has equity securities registered with the Securities and Exchange Commission (SEC) under the federal Securities and Exchange Act of 1934 would be required to file on or prior to August 31 of each year all unitholder information from the partnership's schedule K-1 for the immediately preceding calendar year by paper or electronic format on a form prescribed by the Department of Treasury.

House Bill 4563 would amend the Income Tax Act (MCL 206.365) to require flow-through entities, casino licensees, and race meeting/track licensees to provide a statement of the tax withheld. Under the act, every employer required to withhold taxes is also required to furnish employees with a statement of the amount of compensation and the amount of taxes withheld. The bill would require flow-through entities to provide nonresident members with a statement of the share of income available for distribution and the amount of tax withheld; casino licensees to provide a person with winnings with a statement of the amount of winnings and the amount of tax withheld; and race meeting/track licensees to provide to each payoff on a winning ticket a statement of the amount of the payoff and any tax withheld.

House Bill 4564 would amend the Income Tax Act (MCL 206.451) to require business entities other than a domestic corporation or foreign corporation (as they are already covered under current law) to request a tax clearance certificate, stating that taxes are not due, from the Department of Treasury if they submit a certificate of dissolution or request a certificate of withdrawal from the state.

House Bill 4565 would amend the Income Tax Act (MCL 206.12) to define "flow-through entity", "member of a flow-through entity", and "nonresident member" of a flow-through entity. Under the bill, a flow-through entity would mean an S corporation, partnership, limited partnership, limited liability partnership, or limited liability company. However, a flow-through entity would not include a publicly traded partnership (defined under the federal Internal Revenue Code) that has equity securities registered with the SEC. A member of a flow-through entity would be defined as a shareholder of an S corporation; a partner in a partnership or limited partnership; or a member of a limited liability company. A nonresident member would be an individual who is not domiciled in the state; a nonresident estate or trust; or a flow-through entity with a nonresident member.

BACKGROUND INFORMATION:

These bills are part of a package of bills, proposed by the Granholm Administration, designed to make certain changes in the state's tax laws that are linked to the governor's proposed budget for fiscal year 2003-04.

Under the federal Internal Revenue Code winnings from pari-mutuel wagering at horse or dog racetracks, lotteries, bingo, keno, slot machines, and other gaming activities are considered to be taxable income and subject to withholding and reporting requirements (found on the IRS form W-2G). Gambling winnings for games other than keno, bingo, and slot machines are reportable if the amount won (less the amount of the wager) is \$600 or more and at least 300 times the amount of the wager. Winnings from keno games are reportable if the winnings (less the amount of the wager) are \$1500 or more, and winnings from bingo games or slot machines are reportable if they exceed \$1,200 (not less the amount wagered).

FISCAL IMPLICATIONS:

The Department of Treasury has estimated the bills would increase state revenue by two million annually. (5-7-03)

ARGUMENTS:

For:

These bills, particularly House Bill 4561, are really about fairness in the tax code. It is believed that a significant number of non-resident partners of flow-

through entities do not pay taxes on any income received from that entity. Many are simply unaware that they owe money, while others may knowingly ignore their financial obligations to the state. The bills simply seek to provide the Department of Treasury with the necessary tools and resources to ensure the payment of taxes owed by non-residents. This is accomplished by requiring flow-through entities to withhold the taxes required and encouraging them to file composite income tax returns. It should be noted that this process is standard practice in other states, only concerns the collection of income taxes, and does not create any new tax liability for non-resident members, partners, or shareholders of flow-through entities that operate in the state.

Against:

The bill would extend withholding requirements to winnings from the Detroit casinos and racetracks. That provision, in conjunction with House Bill 4556 - which would treat winnings from the Detroit casinos, the tribal casinos, and the state horse racetracks as taxable income for nonresidents - has the potential to put the Metro Detroit area at a competitive disadvantage with other states that do not tax the winnings of nonresidents. If gamblers choose to take their business to other, more "gambler friendly", areas, the great many hotels, restaurants, conference centers, and other businesses that rely heavily on patrons from the Detroit casinos will undoubtedly suffer. Further, due to the fact that the state cannot impose withholding requirements on the tribal casinos, House Bill 4561 (and House Bill 4556) seems to put the Detroit casinos at a competitive disadvantage with the numerous tribal casinos in the state.

Analyst: C. Couch/M. Wolf

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.