



MOCERI & COMPANY, P.C.
CERTIFIED PUBLIC ACCOUNTANTS

45100 Sterritt Street • Suite 200 • Utica, Michigan 48317-5843
☎ (586) 254-2010 • Fax (586) 254-4856 • ✉ general@moceri-cpa.net

Joseph P. Moceri, C.P.A.
Michael Kramer, C.P.A.

Mary E. Pruss, C.P.A.
Ann Walsh, C.P.A.

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Dear Clients and Friends:

In August, 2007 we issued a letter regarding the new Michigan Business Tax (MBT) that became effective January 1, 2008. As we indicated in that letter, we expected many technical corrections and clarifications to the initial tax details. This has been the case. The State of Michigan has issued 90 plus pages of Frequently Asked Questions (FAQ's) trying to define/clarify many of the issues that business owners and tax professionals have had regarding the details of the new tax. Our professional staff has been attending and will continue to attend seminars so that we can provide you with the latest information regarding the new tax.

We detailed in our August 2007 letter that the MBT was a two-pronged tax. Subsequent to that letter the State of Michigan added a third prong to the tax. To summarize the tax:

Prong 1 Business Income Tax based on the Federal Taxable Income

(Please refer to our August 2007 letter for some of the adjustments that will be made to the Federal taxable income to arrive at the Michigan taxable income subject to a 4.95% tax rate)

Prong 2 Modified Gross Receipts Tax

(Please refer to our August 2007 letter for a listing of receipts that will be excluded as gross receipts that will be subject to a tax rate of .8%) You can locate that letter on our website at www.moceri-cpa.com.

Prong 3 Surcharge Tax

The Surcharge Tax was added to the Michigan Business Tax as a replacement to the Michigan sales tax that **was** going to be imposed on Michigan service companies. The Surcharge tax is imposed at a rate of 21.99%. This rate will be applied to the total of the aforementioned taxes (Business Income Tax and Gross Receipts Tax) before any credits have been applied.

In addition to the Surcharge Tax, we would like to point out some additional information that we have learned regarding the new Michigan Business Tax:

Modified Gross Receipts Tax

- The Modified Gross Receipts tax **excludes the proceeds** from the sale of capital assets and land used in a trade or business, however, **the gain** from a sale of a capital asset or land used in a trade or business **will be included** in gross receipts. Tax planning logic has always dictated that capital losses will offset capital gains and thereby reduce tax liability. This is true for Federal Income tax purposes. However, under the new

Michigan Business Tax – Modified Gross Receipts Tax this **will not** be true. Capital gains will be included in gross receipts. Capital losses **will not** be netted against the capital gains to lower gross receipts.

- The Modified Gross Receipts tax is assessed on the total of any business activity carried out for a gain. The .8% tax rate will be determined after subtracting certain gross receipts and after subtracting purchases from other firms.

Purchases from other firms include:

1. Inventory – *this applies only to retailers, wholesalers or manufacturers (NOT service industries – NOT construction industries)* – where inventory is purchased from an outside person. Inventory has been defined by the State of Michigan under the new MBT to include:
 - stock of goods held for resale in the regular course of trade of a retail or wholesale business
 - finished goods, goods in process and raw materials of a manufacturing business that is **purchased** from an outside source
2. Assets – a subtraction is allowed for current year purchases of depreciable and amortizable assets
3. Materials and supplies, repair parts and fuel – “to the extent not included in inventory or depreciable property” Materials and supplies must be acquired in the current year, must be tangible property and be used integrally with inventory production/management, **and/or** used to maintain and operate depreciable assets.

Note: A service provider or a contractor **will not** have any deduction for materials, supplies, repair parts and fuel used during the course of the year that would be considered cost of goods sold since they have no inventory (per the State of Michigan), however, **they will** be allowed to deduct any materials, supplies, repair parts and fuel used in the maintenance and operation of their depreciable assets.

4. Staffing company compensation
5. Contractor payments to subcontractors

The State of Michigan has identified three Standard Industrial Codes (SIC), covering three types of subcontractors that a general contractor can deduct the payments they have made to them from their adjusted gross receipts. The three major groups are:

- a. 15 – Building Construction General Contractors and Operative Builders (residential, non-residential, operative builders)
- b. 16 – Heavy Construction other than Building Construction Contractors (highway and street, bridge, tunnel, water, sewer, pipeline, communications, power line)
- c. 17 – Construction Special Trade Contractors (plumbing, heating, air-conditioning, painting, electrical, masonry, drywall, tiling, carpentry etc.)

Payments must be made to a subcontractor under a contract *specific to a project* by the contractor.

Note: A contractor **can not** deduct the materials that they purchase for a project. However, if a subcontractor buys all of the materials for the job and the cost of the materials are in the subcontractor's bill, than the total paid to the subcontractor would be deductible against adjusted gross receipts.

6. Film rental or royalty payments

Nexus

The Business Income Tax will be imposed on every taxpayer with business activity in Michigan (unless prohibited by Federal Public Law 86-272)

The Modified Gross Receipts Tax is imposed on every taxpayer with Nexus as determined by the State of Michigan.

Nexus is achieved if a taxpayer has a physical presence in Michigan of at least two days OR if the taxpayer actively solicits sales in Michigan and has greater than \$350,000 in gross receipts in Michigan.

Apportionment

Only those business activities specific to Michigan will be allocated to Michigan. A taxpayer whose has business within and outside of Michigan will have the Michigan tax base apportioned based on the ratio of the Michigan sales to the total sales.

In order to apportion these sales, a Michigan taxpayer **must** establish Nexus (see above) in another state. Once Nexus is established within one state, then a taxpayer can apportion **all** of their gross receipts earned outside of the State of Michigan.

Example One:

A service company has customers in a variety of states other than Michigan. They do not have a physical presence within any of the states. Gross receipts total \$350,000 in only one of the states. The total of the receipts in each of these other states is less than \$350,000. This company has established Nexus and can apportion all of their gross receipts, thus limiting the Michigan gross receipts only to those generated in Michigan. [If the Company did not have gross receipts totaling \$350,000 in one state, they would not have established Nexus EVEN IF the total of receipts earned outside of Michigan totaled more than \$350,000 – see Example Two]

Example Two:

A CPA firm has clients in a variety of states. The total of the receipts in each of these states is less than \$350,000. The owner of the CPA firm attends a two-day conference in a state (where he doesn't have any clients). Nexus has been established by his two day physical presence in another state. The CPA firm can apportion their Michigan gross receipts.

As you can see, and as we stated in our earlier correspondence, the Michigan Business Tax has not simplified the business tax picture in Michigan. We continue to expect many corrections and clarifications as the year progresses. We don't anticipate that the new Michigan Business Tax forms will be available until late 2008.

Please call us if you have any questions. We will be glad to address any concerns that you may have specific to your own business and how it may be affected by the new Michigan Business Tax.

Sincerely,
Moceri & Company, P.C.

Michael Kramer, CPA

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