**INTERNAL POLICY DIRECTIVE 2006-1**

January 17, 2006

**SINGLE BUSINESS TAX**
**SECTION 35 TAX EXEMPTION FOR FLOW-THROUGH ENTITIES**

## POLICY ISSUE

Can a partnership, limited liability company, joint venture, general partnership, limited partnership, unincorporated association, or other group or combination of entities acting as a unit (Hereinafter referred to as a Flow-Through Entity or Entities) receive the exemption provided in MCL 208.35(1)(c) if it conducts business activity that is unrelated to the charitable, educational, or other purpose or function that is the basis for the exemption under the internal revenue code from federal income taxation of its partners or members?

## POLICY DETERMINATION

Yes. MCL 208.35(1)(c) extends the tax exempt status of a Flow-Through Entity's partners or members to the Flow-Through Entity when its business activity is exclusively related to the charitable, educational, or other purpose or function that is the basis for its partners or members exemption under the IRC from federal income taxation.

MCL 208.35(5) provides that "exclusively" is to be defined as the term is applied for purposes of section 501(c)(3) of the IRC. 26 CFR Section 1.501(c)(3)-1 provides the method to be used to determine if an entity's activities are exclusively related to an activity listed in 501(c)(3). Accordingly, a Flow-Through Entity is eligible for the SBT exemption provided in MCL 208.35(1)(c) if it conducts business activity that meets the application of the term exclusively found in 26 CFR Section 1.501(c)(3)-1.

## DISCUSSION

MCL 208.35(1)(c) creates two separate types of entities that are exempt from Michigan's Single Business Tax (SBT). Entities that are exempt from federal income tax under the internal revenue code qualify to be exempt from the SBT. In addition, for tax years beginning on or after January 1, 1996, Flow-Through Entities whose partners and members are tax exempt under the internal revenue code may also qualify to be exempt from the SBT. MCL 208.35(1)(c) states in pertinent part:

> (1) The following are exempt from the tax imposed by this act:
>
> …
>
> (c) A person who is exempt from federal income tax under the internal revenue code, **and**, for tax years that begin after December 31, 1995, a partnership, limited liability company, joint venture, general partnership, limited partnership, unincorporated association, or other group or combination of entities acting as a unit if the activities of the entity are **exclusively** related to the charitable, educational, or other purpose or function that is the basis for the exemption under the internal revenue code from federal income taxation of its partners or members and if all of the partners or members of the entity are exempt from federal income tax under the internal revenue code, except the following: … (emphasis added).

While the statute creates two types of entities that qualify to be exempt from Michigan's SBT, it also provides for exceptions to the exemption at MCL 208.35(1)(c)(i)-(iii):

(i) An organization included under section 501(c)(12) or 501(c)(16) of the internal revenue code.

(ii) An organization exempt under section 501(c)(4) of the internal revenue code that would be exempt under section 501(c)(12) of the internal revenue code but for its failure to meet the requirements in section 501(c)(12) that 85% or more of its income must consist of amounts collected from members.

(iii) The adjusted tax base attributable to the activities giving rise to the unrelated taxable business income of an exempt person.

As a result, a Flow-Through Entity can qualify for the SBT exemption if it meets the following conditions: first it must engage in activity that is **exclusively** related to the charitable, educational or other purpose or function that is the basis for the federal income tax exemption for its members or partners; second, all of its members or partners must be exempt from federal income tax; third, the Flow-Through Entity must not fall under any of the exceptions to the exemption found at MCL 208.35(1)(c) (i)-(iii).

A federally exempt entity can engage in business activity that is unrelated to the charitable, educational, or other purpose or function that is the basis for its federal exemption (unrelated business activity) and still receive the SBT exemption, except for the portion of its tax base attributable to the unrelated business activity. However, a Flow-Through Entity that engages in unrelated business activity may be completely disqualified from the exemption if it is determined that it has unrelated business activity that does not meet the IRC's application of the term "exclusively".

Because MCL 208.35(5) provides that "exclusively" is to be defined as the term is applied for purposes of section 501(c)(3) of the IRC, a review of the federal application is required. The federal application is found in 26 CFR Section 1.501(c)(3)-1 (the “Regulation”), which provides the method to be used to determine if an entity's activities are exclusively related to an activity listed in 501(c)(3).

The Regulation provides a two-part test to determine if an activity is exclusively related to a purpose expressed in IRC 501(c)(3).

The first part of the test is called the organizational test. This test maintains that the entity must be organized exclusively for one or more exempt purposes. This requires that the entity's articles of organization (the articles) limit the purposes of the entity to one or more exempt purposes and that the articles do not expressly empower the entity to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes. 26 CFR Section 1.501(c)(3)-1 (b).

It is clear from the organizational test, that an entity can be organized in a manner that allows an insubstantial part of its activities to be unrelated to one or more of the its exempt purposes. For purposes of the SBT exemption provided to Flow-Through Entities under Section 35 this means the articles of organization of the Flow-Through Entity must make it clear that its main purpose is to engage in the tax exempt activity of its partners or members. For example, if the articles of organization simply state that the Flow-Through Entity can engage in any activity allowed under the laws of its state, it would fail the organizational test. Such a statement clearly allows more than an insubstantial part of the Flow-Through Entity's activities to be unrelated to the tax-exempt purpose of its partners and members. However, if the same statement used above also included language that indicated other unrelated activities may occur but the primary purpose of the Flow-Through Entity is to engage in activities related to the tax exempt purpose of its partners and members, the Flow-Through Entity would likely pass the organizational test.

The second part of the test is referred to as the operational test. This test states that an entity will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of the exempt purposes specified in IRC 501(c)(3). An entity will not meet the operational test if more than an insubstantial part of its activities are not in furtherance of an exempt purpose. 26 CFR Section 1.501(c)(3)-1(c).

Again, the key issue with this test involves the meaning of insubstantial. For purposes of Section 35 of the SBTA it shall be prima facie evidence that an unrelated activity is insubstantial if it accounts for less than 10% of the Flow-Through Entity's gross receipts. The Department may also allow a cost comparison, when available, to determine if an unrelated activity is insubstantial. The comparison shall be based on the costs associated with performing the exempt activity compared to the costs associated with performing the unrelated activity.

Accordingly, a Flow-Through Entity that meets both the organizational and operational test will be regarded as having business activity that is exclusively related to the charitable, educational, or other purpose or function that is the basis for the exemption under the internal revenue code from federal income taxation of its partners or members. This is true even if it engages in unrelated business activity.

However, the unrelated business activity must be insubstantial. Further, in accordance with MCL 208.35(c)(1)(iii) the adjusted tax base attributable to the unrelated business activity is subject to the SBT.