Legislative Analysis

Mitchell Bean, Director
Phone: (517) 373-8080
http://www.house.mi.gov/hfa

INCOME TAX WITHHOLDING FOR NONRESIDENT HOUSING ASSOCIATION MEMBERS

House Bill 4338
Sponsor: Rep. Joel Sheltrown
Committee: Tax Policy

Complete to 3-26-07

A SUMMARY OF HOUSE BILL 4338 AS INTRODUCED 3-1-07

The bill would amend the Income Tax Act (MCL 206.351) to address flow-through entities that have a regulatory agreement with MSHDA, HUD, or the USDA that requires agency approval for cash distributions to association members. Under the bill, these entities would be required to deduct and withhold taxes on cash distributions made to non-resident members in the tax year and approved under the regulatory agreement. (In essence, under the bill, a withholding payment would be required only when there is an actual cash distribution made.)

The organizational references are references to the Michigan State Housing Development Authority, the federal Department of Housing and Urban Development, and the United States Department of Agriculture.

FISCAL IMPACT:

The bill would reduce income tax revenue by less than $1 million.

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" which 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 P.A. 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 individual 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 requires flow-through entities to withhold taxes on the share of taxable income available for distribution of non-resident members of the entity, after deducting from that distributive income the appropriate amount for personal and dependency exemptions. [The bill specifies that, "share of taxable income available for distribution of each non-resident member" and "distributive income" – for the purposes of flow-through entities with a regulatory agreement with MSHDA, HUD, or the USDA – means cash distributions approved under the agreement and actually made during the tax year.]

The non-resident withholding requirements were added to the Income Tax Act with the enactment of Public Act 22 of 2003 and became effective beginning October 1, 2003, as part of an effort to increase compliance with the act by non-resident members of flow-through entities. The act defines "flow-through entity" to mean an S-Corporation, partnership, limited partnership, limited liability partnership, or limited liability company. Flow-through entity does not include a publicly traded partnership that has equity securities registered with the Securities and Exchange Commission. A non-resident member of a flow-through entity is a shareholder of an S-Corporation, partner in a partnership or limited partnership, or a member of a limited liability company that is an individual not domiciled in the state, or a non-resident estate or trust.

The Income Tax Act's non-resident withholding requirements raise two issues relative to limited dividend housing associations:

1. Many associations do not have surplus cash available to make withholding payments, meaning that 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 individual partner or member (paying the partner's tax obligation or refunded to the partner when it exceeds the partner's 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.

Note: The bill, as introduced, is identical to HB 6167 (H-1) of the 2005-06 legislative session. That bill, introduced by Rep. Sheen, passed the House on November 28, 2006 by a vote of 104 (Y) to 1 (N), and died in the Senate Finance Committee with the adjournment of the 2005-2006 legislative session.

Legislative Analyst: Mark Wolf
Fiscal Analyst: Rebecca Ross