SFA BILL ANALYSIS

Senate Fiscal Agency • Lansing, Michigan 48909 • (517) 373-5383

Senate Bill 360 (as reported without amendment)
Sponsor: Senator Dick Posthumus
Committee: Finance

Date Completed: 5-18-88

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RATIONALE

The Intangibles Tax Act levies a tax on intangible personal property, such as shares of stock, land contracts, bonds, securities, and other items listed in the Act. Shareholders in regular corporations and S corporations are taxed in the same manner under the Act, while income from partnerships is excluded from taxation. Some people feel that subjecting S corporation shareholders to the intangibles tax is improper, pointing out that S corporations are much like partnerships for purposes of Federal taxes.

Under the Internal Revenue Code, an S corporation is defined as a small business corporation for which an election to be an S corporation is in effect. A small business corporation is defined as a domestic corporation that does not: have more than 35 shareholders; have more than one class of stock; have a shareholder, other than an estate or trust, who is not an individual; and, have a shareholder who is a nonresident alien. A small business corporation elects to be an S corporation by consent and election of the shareholders according to procedures in the Code. An election can be terminated in any one of three ways: shareholders holding more than one-half of the shares consent to revocation of the election; the corporation ceases to be a small business corporation; or, certain types of investment income exceed 25% of gross receipts for three consecutive taxable years.

Because of the restrictions placed on S corporation structure, it is claimed, S corporations tend to be small, family operated businesses that attract active, rather than passive, investors—thus another similarity to partnerships and a further argument that shareholders should be exempted from the intangibles tax as are partners. It has also been argued that the intangibles tax discourages the creation of S corporations in Michigan because, in effect, some earnings can possibly be taxed three times. The shareholder must pay the intangibles tax on the shares held and the State income tax on earnings from the shares, and the corporation must pay the single business tax. For these reasons it has been suggested that S corporations be exempted from the intangibles tax.

CONTENT

The bill would amend the Intangibles Tax Act to exempt from the intangibles tax the interest of a shareholder in a small business corporation (an "S corporation" as defined in the Federal Internal Revenue Code). Under the bill, if a small business corporation election were terminated under the Internal Revenue Code, meaning that the corporation was no longer an S corporation, the interest of shareholders would be taxable under the Act. The bill would take effect July 1, 1987.

MCL 205.131

FISCAL IMPACT

The bill would result in a reduction of General Fund/General Purpose revenues of approximately $10 - $12 million per year. This estimate is based on a 1983 U.S. Internal Revenue survey and a Senate Fiscal Agency estimate of growth since then. Because of the Federal Tax Reform Act of 1986, the top corporate income tax rate is now higher than the top individual rate for the first time in many years. As a result, the number of corporations choosing S status is expected to increase dramatically. It is therefore possible that the revenue loss could be greater than expected in future years. On the other hand, should the passage of this bill lead to a significant increase in businesses choosing S status, increased income tax collections would offset part of the direct revenue loss. For example, the Senate Fiscal Agency estimates that a 10% increase in S corporations would increase income tax revenues by approximately $800,000 per year.

ARGUMENTS

Supporting Argument

Imposition of the intangibles tax on shareholders of S corporations is unfair to shareholders and bad for business in Michigan. In addition to S corporation earnings being taxed at 2.35% under the single business tax, shareholders must pay a 4.6% income tax and a 3.5% intangibles tax on distributions. This is a burdensome tax structure, and a discouragement to the formation of S corporations at a time when firms that are eligible to form an S corporation have an incentive to do so. Under the Federal Tax Reform Act of 1986, the highest marginal tax rate to individuals is 28%, while the highest marginal rate on regular corporations is 34%. Because S corporation earnings under Federal law are considered passed through to the shareholders, the earnings are taxed at the 28% rate. It is clearly an advantage for an eligible firm to choose S corporation status to reduce the Federal tax burden on the shareholders; however, the intangibles tax works against this logic.

S corporations are treated much like partnerships for Federal tax purposes. Further, because of the limits placed on their structure, S corporations tend to attract shareholders who are active in the firms as partners are active in partnerships. By exempting S corporation earnings from the intangibles tax, as are partnership earnings, the bill would provide for a consistent State tax policy.

OVER

Opposing Argument

The intangibles tax is a proper tax and should continue to be levied on S corporation disbursements, and partnerships and S corporations should continue to be treated differently for tax purposes. Partnerships are exempted under the Act because disbursements are not treated as capital but as wages and benefits; that is, the partners actively participate in the actions of the firm and are paid for their participation. S corporation shareholders, on the other hand, don't necessarily have to participate in the activity of a firm; even though Federal tax law places a ceiling on the passive investment income earned by an S corporation, shareholders can be passive members of the corporation. In fact, the Department of Treasury reports that S corporation earnings that are disbursed to active shareholders as wages or benefits, instead of shareholder dividends, are not subject to the intangibles tax. This weakens the contention that all shareholders in S corporations should be treated as partners in partnerships for tax purposes, because those shareholders who receive disbursements as wages and benefits are already not subject to the intangibles tax.

Opposing Argument

The State can ill-afford the estimated $10-$12 million lost revenue that the bill would cause, and would be ill-advised to erode its tax base further.

It must be remembered that the intangibles tax is a tax based on the ownership of intangible personal property, not on income. Saying that it is an unfair tax is like saying that those who pay income tax should not have to pay sales tax when they use the income; these are two entirely separate and proper taxes. In addition, the claim that S corporations are subjected to single business tax liability deserves further study. Many S corporations are small businesses, and many small businesses pay little or no single business tax. Also, the Single Business Tax Act contains special credits that S corporations can claim. It may be that there are few S corporations that have significant single business tax liabilities.

Response: The cost estimate of the bill could be overstated. While exempting S corporation shareholders from the intangibles tax would reduce that tax revenue, increased income tax revenues would be expected because of the increased numbers of firms organizing as S corporations; while the disbursements of regular corporations only are subject to the income tax, all the earnings of an S corporation would be taxed as income because they would pass through to the stockholders.

Legislative Analyst: G. Towne
Fiscal Analyst: N. Khouri

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