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BILL ANALYSIS

Senate Fiscal Agency

Lansing, Michigan 48909

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**Senate Bill 824 (Substitute S-3 as reported)****Sponsor: Senator Vernon Ehlers****Committee: Finance****Date Completed: 11-7-88****RATIONALE**

The State's income tax is closely tied to the Federal income tax — State taxable income is based upon Federal adjusted gross income (AGI). The effects of the numerous changes made by the Federal Tax Reform Act of 1986 on the State Income Tax Act, many feel, warrant changes in State tax laws so that persons don't end up paying higher State taxes because of the Federal changes. For instance, the 1986 Federal Act removed the ability of dependents, mostly minors, to claim a personal exemption for themselves if they are claimed as a dependent by another taxpayer. For Federal tax purposes, loss of the personal exemption was offset by lower tax rates and, for non-itemizers, an increased standard deduction. The loss of the personal exemption, however, increased State income tax liabilities for such persons since State tax forms are based on Federal tax calculations; persons can claim on their State tax form only the number of exemptions they claim on their Federal form. This meant that, without the personal exemption, a dependent's income became taxable from the first dollar earned. In response to this situation, the Legislature passed Public Act 1 of 1988 to provide that, beginning with the 1987 tax year, a person who had a Federal AGI of \$1,500 or less and was a dependent would be exempt from State income tax liability. While this action helped those persons who earned \$1,500 or less, it did nothing for dependents who earned over \$1,500 — a dependent who earned \$1,600, for instance, had to pay tax on that amount from the first dollar earned because he or she could not claim a personal exemption. It has been suggested that, for the 1988 tax year at least, dependents be allowed to claim a personal exemption against the State income tax, as they could prior to passage of the 1986 Federal Act.

In addition, before the 1986 Federal Act, certain business and moving expenses were excluded from the computation of Federal AGI, either because they were not included as income or because they were deducted after the computation of AGI. Since State taxes are based upon AGI, these expenses were not subject to State taxes. The 1986 Federal Act, however, requires inclusion of these expenses in AGI. Although other changes limited the affect this had on taxpayers' Federal tax payments, these expenses are now subject to State income taxes. It has been pointed out that this change has been particularly burdensome to salespersons and employees who are not reimbursed for business and moving expenses, but are required to include those expenses as part of AGI. Some people feel that persons should be allowed to deduct from State taxable income amounts up to the amounts deducted or excluded from AGI for business and moving expenses under the Internal Revenue Code.

**CONTENT**

The bill would amend the Income Tax Act to provide that, for the 1988 tax year, a person not allowed to claim a personal exemption under the Internal Revenue Code (i.e., a dependent) would be allowed a \$1,800 personal exemption against State income tax liability. The bill would repeal provisions under which a person who is not allowed to claim a personal exemption under the Internal Revenue Code, and who has an adjusted gross income of \$1,500 or less, is exempt from the State income tax (MCL 206.52).

For the 1988 tax year only, the bill also would allow a person to deduct from taxable income, to the extent not deducted in calculating Federal adjusted gross income, "business expenses" in conducting a trade or business as described in the Internal Revenue Code. (Under the Code, "business expenses" means all ordinary and necessary expenses paid or incurred in doing business, including a reasonable allowance for payments for personal services rendered, and travel expenses including meals and lodging while away from home in pursuit of business.) The bill specifies that a taxpayer could deduct these expenses whether or not he or she were considered an employee under the Internal Revenue Code, or the deducted expense were considered a miscellaneous itemized deduction under the Code. The bill would allow a deduction equal to or less than the amount that would qualify as a deduction for miscellaneous itemized deductions under the Code, subject to the Code's 2% limit. (The Code allows a taxpayer to deduct for miscellaneous deductions only those expenses that exceed 2% of adjusted gross income.) A taxpayer could not claim a deduction under the bill unless his or her return was accompanied by a copy of the Federal form on which the expense was itemized.

The bill also would allow a taxpayer to deduct, for the 1988 tax year only, the amount paid or incurred during the year for employment-related moving expenses, up to the amount that would qualify for the moving expense deduction allowed under the Code.

MCL 206.30

**FISCAL IMPACT**

The proposed changes in Senate Bill 824 would lead to an annual reduction in General Fund/General Purpose revenues of \$55 to \$65 million per year. For more details see the Senate Fiscal Agency memorandum dated October 12, 1988.

**ARGUMENTS****Supporting Argument**

Because of changes made by the Federal Tax Reform Act of 1986, some taxpayers have found that their treatment under the State Income Tax Act has been worsened. For

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instance, minors or others who can be claimed as a dependent by another taxpayer for the purpose of Federal taxation can no longer claim a personal exemption against the State income tax. While Public Act 1 of 1988 alleviated the problem somewhat by exempting dependents who earn \$1,500 or less, it failed to restore the personal exemption for those dependents who make more than \$1,500. The current situation, in effect, creates a tax precipice: a dependent earning \$1,500 is exempt but a dependent earning \$1,501 is liable for tax on the entire amount. This is an especially burdensome tax for students who can be claimed by their parents as dependents but need to earn as much money as possible to help themselves get through school.

### ***Supporting Argument***

Many persons who have business and moving expenses have found their State tax liabilities increased substantially because these items are now included as part of AGI. This change has been particularly unfair to salespersons and employees who have unreimbursed business and moving expenses; in effect, these taxpayers must include the expenses as part of their income and thus pay taxes on those expenses without receiving reimbursement, while other employees with similar positions pay those taxes but are reimbursed. The bill would correct this inequity and restore the tax treatment of business expenses to a position similar to its status prior to the 1986 Federal Act.

### ***Opposing Argument***

Passage of the 1986 Federal Act resulted in many changes for the State's taxpayers and caused an increase in revenue collections under the State income tax. In response to this increase in taxation, a broad-based solution was adopted to minimize increased collections by increasing the personal exemption for all taxpayers except dependents, and exempting those dependents with an income under \$1,500. There could be numerous examples where quirks in the Income Tax Act, as affected by the changes in Federal taxes, have caused individual groups of taxpayers to experience slight or moderate tax increases. Rather than address the problems of each group, it was decided to return money to the taxpayers by trying to reduce everybody's tax liability. If each group of taxpayers that was affected by the changes now tried to address its problems separately, the entire Act would have to be restructured and, likely, the increased personal exemption would have to be reduced because the changes would significantly reduce State revenues.

**Response:** The issue is whether the State should return money to those who have, through no effort of the State or its decision-makers, had their taxes increased. If one group of taxpayers (such as dependents) is treated differently than another group, the laws should be adjusted to equalize the situation. The current system of not taxing those who earn less than \$1,500, but fully taxing those who earn \$1,501 is inequitable and only encourages cheating. Further, it is simply not right for the State not to act to correct a system that inadvertently raised the taxes of persons with business and moving expenses. While the State attempted, by increasing the personal exemption, to return to the taxpayers money it had not expected to collect, that is not a justification for ignoring or resisting solutions that could fairly address the problems of individuals who continue to experience significant tax increases as a result of the 1986 Federal Act.

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