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**SFA****BILL ANALYSIS**

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House Bill 4773 (Substitute S-1 as reported by the Committee of the Whole)

Sponsor: Representative Kirk A. Profit

House Committee: Tax Policy

Senate Committee: Finance

Date Completed: 10-14-97

### **RATIONALE**

The Single Business Tax (SBT) Act exempts from the tax that portion of a taxpayer's tax base that is attributable to the production of agricultural goods, if the taxpayer's primary activity is the production of agricultural goods. "Production of agricultural goods" means commercial farming including, but not limited to, cultivation of the soil; growing and harvesting of an agricultural, horticultural, or floricultural commodity; dairying; raising of livestock, bees, fish, fur-bearing animals, or poultry; or turf or tree farming. It does not include the marketing at retail of agricultural goods, meaning that such activity is not tax exempt. A dispute has developed concerning what constitutes "marketing at retail" in the sale of nursery stock. Sales of nursery stock by growers to customers other than nursery dealers (such as walk-in customers, households, etc.) have always been considered taxable transactions under the SBT Act; that is, the sales must be included in the growers' SBT base. Reportedly, sales to nursery dealers (wholesalers, distributors, etc.) have been treated by some growers as wholesale transactions and therefore not taxable, while others have included such sales in their tax bases. The Department of Treasury recently determined that the sale of nursery stock by one grower to landscape contractors constituted "marketing at retail" and was therefore to be considered as part of the grower's tax base under the SBT. It has been pointed out by the Michigan Nursery and Landscape Association, however, that other sales by growers (to other nurseries, retailers, secondary wholesalers) are not considered marketing at retail and are tax exempt to the seller. It has been suggested that all wholesale sales of nursery stock by growers should be exempt under the Act.

Further, the treatment of tax-exempt farmers' cooperatives versus nonexempt cooperatives under the SBT Act has resulted in confusion and dispute.

In general, a taxpayer who is exempt from Federal corporate income tax is exempt from the SBT, so exempt farmers' cooperatives are exempt from the SBT. Since the SBT Act does not contain language that specifically exempts nonexempt cooperatives, even though those cooperatives often have little or no Federal tax liability, those cooperatives traditionally have been required to include in their tax bases revenue and expenses attributable to business transacted with their patrons. According to the Michigan Farm Bureau, after a Department of Treasury audit of a farmers' cooperative concluded in 1992, the cooperative was told by the Department that it should deduct revenue and expenses from its tax base, rather than include them. Reportedly, the cooperative complied with the advice, as did other cooperatives that were informed of the Department's decision; however, a subsequent audit of another cooperative for later years advised the cooperative that, since the SBT Act has no language to allow a cooperative to exclude revenue and expenses from its tax base, revenue and expenses must be included. It has been suggested that to clarify the situation, since many farmers' cooperatives have for several years excluded revenue and expenses from their tax bases, the Act should be amended specifically to allow for such an exemption.

### **CONTENT**

The bill would amend the Single Business Tax Act to exempt from the tax sales of nursery stock grown by a seller and sold to a nursery dealer licensed under the Insect Pest and Plant Disease Act. Further, the bill states that its provisions, "...are curative and intended to express the original intent of the legislature in the definition of production of agricultural goods".

Under the Insect Pest and Plant Disease Act, "nursery stock" means all botanically classified hardy perennial or biennial trees, shrubs, vines, and plants, either domesticated or wild, cuttings, grafts, scions, buds, bulbs, rhizomes, or their roots, fruit pits; and other plants and plant parts for, or capable of, propagation, except field, vegetable and flower seeds, corms and tubers. A "nursery dealer" is a business that is not a grower or an original producer of nursery stock, that buys nursery stock for the purpose of reselling or reshipping independently of the control of any person or business that owns or manages a nursery.

The bill also would amend the SBT Act to provide that, effective for tax years after 1990, a farmers' cooperative corporation would have to exclude from its adjusted SBT base revenue and expenses attributable to business transacted with farmer or farmer cooperative corporation patrons, to whom net earnings were allocated in the form of patronage dividends as defined in the Internal Revenue Code.

"Farmers' cooperative corporation" would mean a cooperative association as described in Section 98 of Public Act 327 of 1931, which provides that a corporation must be governed under the Act if it is organized to conduct a lawful business that limits the dividends, payable upon stock investment in the case of a corporation with capital stock, or membership investment in the case of a membership corporation without capital stock, not to exceed 8% per annum; or that limits the voting rights of stockholders or members to one vote regardless of the number of shares of stock or membership held; and that in any case does not conduct more than 50% of its business or services with nonstockholders or nonmembers.

Currently, certain farmers' cooperative corporations that are exempt from Federal income taxes, and that are organized under certain limitations of Public Act 327 of 1931, are exempt from the SBT. This exemption does not apply to a farmers' cooperative corporation if the total dollar value of its incidental and emergency purchases (of commodities from nonproducers to facilitate the manufacture or marketing of commodities purchased from producers) is at least 5% of the total dollar value of its repurchases (from nonproducer customers of commodities the corporation markets to nonproducer customers and the corporation's subsequent manufacture or marketing of the repurchased commodities). Under the bill, for tax years ending after 1994, the

exemption would not apply if the incidental and emergency purchases were at least 5% of the corporation's total purchases.

MCL 208.35

## **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

### **Supporting Argument**

The bill would clarify that sales of nursery stock by nurseries to landscape contractors, or any nursery dealers, would not be part of a nursery's tax base and would therefore be exempt from the SBT. It has been argued that considering such sales to landscapers as retail sales is inaccurate because those sales are wholesale transactions, as the nursery stock is subsequently resold to customers for installation by the landscape contractors. This would make the sale of nursery goods for the purpose of resale consistent for all such sales. Nurseries would remain subject to the SBT when selling goods at retail to all other customers.

### **Supporting Argument**

The tax treatment under the SBT Act of Federally nonexempt farmers' cooperatives has become the subject of dispute. Under Federal law, a nonexempt cooperative that distributes its profits to its members based on membership activity can deduct those distributions from its tax base, leaving the cooperative itself with little or no tax liability, while the members who received the distributions assume liability for tax on them. In this manner the income is taxed only once at the Federal level. Under the SBT, a farmers' cooperative that is exempt from Federal taxation also is exempt from the SBT; however, the Act does not offer the same specific exemption to a farmers' cooperative that is nonexempt for Federal tax purposes. This means, then, that while a nonexempt cooperative may have no Federal tax liability it may have to include in its SBT base revenue and expenses that were deducted on its Federal return.

Reportedly, a 1992 Department of Treasury audit of a nonexempt farmers' cooperative advised the cooperative that it should exclude from its SBT base revenue and expenses attributable to transactions with patrons. In an audit of another cooperative some years later, the cooperative was advised that it could not exclude such revenue and expenses since the Act does not specifically allow such an exclusion. Many cooperatives, having

been informed of the Department's first advice to exclude revenue and expenses, have not included those items on returns in recent years, thus potentially leaving them liable for substantial back taxes, interest, and penalties. The bill would clear up the current confusion over whether revenue and expenses should be included in a cooperative's tax base, relieve those cooperatives that have been excluding revenue and expenses from having to file costly amended returns, and make Michigan's tax treatment of nonexempt cooperatives parallel to that of the Federal government.

### **Opposing Argument**

Under the SBT Act those cooperatives that maintain their Federal tax-exempt status specifically are exempt from the SBT, but those that do not have a Federal exemption or lose their Federal exemption have no specific tax exemption under the Act. As such, the Department of Treasury is bound to administer the provisions of the Act as written. Those nonexempt farmers' cooperatives that have not included in their tax bases revenue and expenses, attributable to business transacted with cooperative patrons who received patronage dividends, have not been following the law and are therefore liable for the resultant taxes, interest, and penalties. The bill would eliminate the Department's ability to enforce the Act as it is written.

**Response:** Because there has been confusion over the interpretation of what a cooperative should and should not include in its tax base, the fair course of action would be to clarify the language of the Act and make it conform with the recent filing practices of certain cooperatives.

Legislative Analyst: G. Towne

### **FISCAL IMPACT**

The proposed changes in the single business tax on tree nursery growers and sellers, and farm cooperatives, would reduce SBT liabilities by an estimated \$3 million in FY 1997-98 and by \$2.5 million in FY 1998-99. The proposed exemption on the sales made by nursery stock growers to retailers and landscapers would reduce revenue by an estimated \$1 million in FY 1997-98, which reflects refunds that would have to be made because the change would be retroactive, and by less than \$0.5 million in FY 1998-99. Farm cooperatives have been underpaying their SBT liability and this bill would make the SBT consistent with their recent practice. This change would reduce the tax liability of farmer cooperative corporations by about \$2 million in FY 1997-98

compared with what it would be under current law.

Fiscal Analyst: J. Wortley

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.