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BUSINESS TAXES: GOV.'S PROPOSAL

House Bills 4744 and 4745 as enrolled
Public Acts 117 and 115 of 1999
Sponsor: Rep. Nancy Cassis

Senate Bill 544 as enrolled
Public Act 116 of 1999
Sponsor: Sen. Mike Rogers

House Committee: Tax Policy
Senate Committee: Finance
First Analysis (7-16-99)

THE APPARENT PROBLEM:

Single Business Tax. Governor Engler has proposed a 23-year phase-out of the state's single business tax (SBT), along with a number of related business tax proposals. The SBT, in effect since 1975, is a unique value-added tax based on business activity rather than, say, corporate income (profits) or gross receipts. Reportedly, no other state has a tax like it. (See Background Information.) It brings in about two-and-one-half billion dollars in revenue each year from some 90,000 taxpayers (out of an estimated 250,000 businesses in the state). Critics charge that it is a complicated, confusing, onerous, anticompetitive, burdensome tax that penalizes job creation and discourages economic development. Business representatives are offended that companies must pay taxes even when they do not make a profit; owners of smaller businesses complain that compliance costs, including accounting fees, can outstrip tax liability. Some others, including defenders of the tax, say that the SBT has been amended too often in ways that contradict its underlying theories, in particular by narrowing the base of the tax and reducing the number of businesses with tax liability. Critics also point out that it has been subject to a great deal of litigation -- "a lawsuit magnet", one business spokesman has called it -- and some people fear that the current capital acquisition deduction (CAD) in the SBT act will not stand up to a constitutional challenge. In announcing his proposal to phase out the SBT, Governor Engler said, "This will be a major new incentive for investment. We will make Michigan more competitive and attract thousands of new, high paying jobs to Michigan instead of other states or countries."

Apportionment/Industrial Processing. In Michigan Bell v Department of Treasury, a 1998 Michigan Court of Appeals case, the court ruled that the treasury department had no statutory authority for its practice of apportioning the exemption for telecommunications equipment based on exempt and non-exempt uses of the equipment. It supported the reasoning of the Michigan Tax Tribunal, which had said the equipment should be entirely exempt because "the equipment is used from the very outset and constantly thereafter for exempt purposes and the exempt use is substantial." State tax officials have expressed concern about the effect of this reasoning, especially if it is applied beyond telecommunications equipment to the industrial processing exemption generally. Equipment used in industrial processing is exempt from the sales and use taxes. Some equipment is used for both exempt and non-exempt purposes, and the Department of Treasury's longstanding practice has been to apportion the exemption for that equipment based on its use. The state could be faced not only with a significant loss of future revenue from this decision, but also would have to pay large amounts of refunds immediately for the years covered by the decision. Further, the industrial processing exemption provisions in the two acts are themselves in need of revision.

Bad Debts. The same appeals court decision said that the Use Tax Act should be read to include a bad debt deduction just like the one found in the General Sales Tax Act, which does not require taxes to be paid by businesses when bills are uncollectible. That issue needs to be addressed statutorily.

Business Restructuring. Tax specialists say that businesses that restructure or spin off part of the firm in order to compete more effectively sometimes face higher SBT liabilities as a result. The governor's tax proposal addresses that problem.

Rolling Stock Exemptions. Amendments to both the sales tax and use tax in 1996 provided exemptions to interstate truckers for purchases of "rolling stock" (i.e., large trucks, trailers and parts). The exemptions carried a sunset date of May 1, 1999. Legislation was subsequently introduced to remove that sunset, extending the exemptions indefinitely and expanding them somewhat. A discussion of this issue can be found in the analysis of House Bill 4586 (dated 5-12-99), and an earlier discussion of the same topic can be found in the analysis of House Bill 5506 of the 1995-96 session (dated 2-3-97).

Hospital Construction Exemption. Typically, nonprofit entities enjoy exemptions from the sales and use taxes when making purchases but contractors carrying out construction work for nonprofits have not been exempt since 1970, with the exception of contractors working on nonprofit hospitals and certain nonprofit housing. There was no statutory definition of the term "hospital" for many years, with the department depending on a promulgated rule. This led to disputes, and legislation enacted in 1998 put a definition in statute that only applied for exemptions after 1990 and before 1996. This issue needs to be addressed again to clarify the institutions that qualify for the contractor exemption.

THE CONTENT OF THE BILLS:

House Bill 4745 would amend the Single Business Tax Act (MCL 208.3 et al.) in order to:

** Phase out the SBT by reducing the rate from the current 2.3 percent by one-tenth of one percent per year. The rate would be reduced to 2.2 percent effective January 1, 1999. The rate would reach zero on January 1, 2021 and the act would be repealed. However, the rate reduction would be halted in any year in which the amount in the counter cyclical budget and economic stabilization fund (rainy day fund) was at $250 million or less.

** Replace the apportioned capital acquisition deduction with an unapportioned investment tax credit, effective after December 31, 1999.

** Beginning on January 1, 2000, apply the SBT to certain "foreign persons" based on business activity in the United States, including sales and services in the country and compensation paid to employees, officers, and directors for services performed in the United States, whether or not the individual or business entity was subject to taxation under the federal Internal Revenue Code.

** Reduce the tax base of "spun off" companies by excluding sales for five or seven years between companies that had been members of an affiliated group until a restructuring, in cases where such a restructuring would otherwise result in an increased tax liability.

House Bill 4744 and Senate Bill 544 would amend the Use Tax Act and the General Sales Tax Act, respectively, to:

** Place into statute the Department of Treasury's practice (following a rule) of apportioning industrial processing exemptions based on exempt and non-exempt uses of equipment, with the provision to apply retroactively. However, such apportionment would be only prospective for certain specified telecommunications equipment.

** Provide an "irrebuttable presumption" that for the abovementioned telecommunications equipment, 90 percent of the total use is provided for exempt purposes. The presumption would be in effect until April 1, 2006, at which time it would be reviewed and redetermined by the Department of Treasury. The department would use non-exempt and exempt user information for the previous 12-month period in making the redetermination, which would be in effect for seven years. The irrebuttable presumption would be reviewed and redetermined every seven years thereafter.

[The telecommunications equipment is that already specified in the act as exempt: machinery and equipment for use or consumption in the rendition of services taxable under the Use Tax Act, but limited to property located on the premises of the subscriber and to central office equipment or wireless equipment, directly used or consumed in transmitting, receiving, or switching, or in the monitoring of switching of a two-way interactive communication. The equipment does not include distribution equipment including cable or wire facilities.]

** Rewrite, in order to clarify and expand, the industrial processing exemptions in each act.

** Allow a bad debt deduction for the use tax parallel to that which exists for the sales tax.

** Rewrite the exemption for property purchased by a person engaged in constructing, altering, repairing, or improving real estate for others when the property was affixed to and made a structural part of a nonprofit hospital.

** Exempt "rolling stock" (certain large trucks, trailers, and parts) from the sales tax when purchased by an interstate motor carrier or for rental or lease to an interstate motor carrier and used in interstate commerce. (A similar use tax provision is found in House Bill 4586.)

The three bills are tie-barred to one another. They are described in more detail separately below.

Single Business Tax (House Bill 4745)

SBT Rate Reduction. The bill would provide that beginning January 1, 1999 and each January 1 thereafter, the SBT tax rate would be reduced by one-tenth of one percent if the comprehensive annual financial report of the state published under the Management and Budget Act reported an ending balance of more than $250 million in the counter cyclical budget and economic stabilization fund. The Department of Treasury would annualize the rate as necessary. The SBT act would be repealed on the January 1 of the year in which the rate was reduced to zero percent.

Investment Tax Credit/Capital Acquisition Deduction. The bill would provide a new investment tax credit (ITC) against the SBT for tax years beginning after December 31, 1999. The current capital acquisition deduction (CAD) would apply for tax years before January 1, 2000. The bill contains a formula for determining the allowable costs of tangible assets to be used in calculating the credit, and requires that the assets be physically located in the state for use in a business activity in this state. It refers to the cost, including fabrication and installation, paid or accrued in the taxable year of tangible assets of a type that are, or under the federal Internal Revenue Code will become, eligible for depreciation, amortization, or accelerated capital cost recovery for federal income tax purposes. (There are separate provisions for mobile tangible assets, which would be subject to apportionment in the same manner as the tax base; and for assets purchased or acquired for use outside the state and then moved into the state.) Once the costs have been calculated, they would be multiplied by a percentage determined by dividing the tax rate for the tax year in which the credit was being claimed by 2.3 and multiplying that result by 0.85.

If the credit for a tax year and any unused carry forward exceeded the taxpayer's tax liability, the excess would not be refunded but would be carried forward as an offset to tax liability for nine taxable years or until used up, whichever occurred first. The credit would have to be taken before any other credit under the act. For a year in which the amount calculated by using the formula and multiplying by the appropriate percentage was negative, the absolute value of that amount would be added to the taxpayer's liability for the tax year. A taxpayer that used the gross receipts deduction to calculate its tax base could not claim the investment tax credit. A taxpayer that reduced its adjusted tax base using the excess compensation deduction would reduce the investment tax credit by a percentage determined by dividing the SBT rate by the ITC rate.

[The current CAD is a deduction from the tax base and is subject to the same apportionment formula as the SBT tax base; that is, 5 percent payroll, 5 percent property, and 90 percent sales. The new ITC would not be apportioned; it would be a credit subtracted from tax liability.]

Foreign Taxpayers. The bill would provide that for tax years beginning January 1, 2000, the tax base of a "foreign person" would include the sum of business income and certain specified adjustments related to U.S. business activity, whether or not the foreign person was subject to taxation under the federal Internal Revenue Code. (This section would not apply to insurance companies.) A foreign person would have to calculate compensation by reporting total compensation paid to employees, officers, and directors for services performed in the U.S.

The term "foreign person" would mean either 1) an individual who was not a U.S. resident, whether or not the individual was subject to taxation under the federal Internal Revenue Code; or 2) a person formed under the laws of a foreign country or a political subdivision of a foreign country, whether or not the person was subject to taxation under the federal Internal Revenue Code. The term "business income" would refer to gross income attributable to the

taxpayer's U.S. business activity and gross income derived from sources within the U.S. minus the deductions allowed under the federal Internal Revenue Code related to that gross income. Gross income includes the proceeds from sales shipped or delivered to any purchaser within the U.S. and for which title transfers within the U.S.; proceeds from services performed within the U.S.; and a pro rata proportion of the proceeds from services performed both inside and outside the U.S. based on cost of performance. The terms "United States corporation" and "United States person" are found in the federal Internal Revenue Code.

Industrial Restructuring Deduction. The bill would allow certain taxpayers to exclude certain sales when calculating the sales factor that is used to determine the SBT base for either five or seven years. The provision would apply to a "spun off corporation" that had been included in a combined or consolidated return in the immediately preceding tax year; ceased to be included in the combined or consolidated return as a result of a restructuring transaction that occurred after January 1, 1999; and whose SBT liability would otherwise have been increased as a result of the restructuring transaction. Such companies could exclude sales to a purchaser that had been a member of the same affiliated group that had included the seller in the filing of a combined or consolidated annual return but ceased to include the seller as a result of a restructuring transaction. (This means sales by a spun off corporation to an entity that had been a member of the same affiliated group until a restructuring would be excluded from the tax base.)

To qualify for this deduction for five years, the spun off corporation would have to request approval in writing from the state treasurer and commit to an investment of at least $500 million of capital investment within the state within five years. The five-year period would begin with the first tax year following the tax year in which the restructuring was completed. The deduction would be available for an additional two years if the corporation made a similar request prior to the end of the sixth year following the restructuring committing to invest at least $200 million of capital investment during the next two years. If a corporation failed to make the required capital investment (in either case), it would be required to file amended returns, regardless of the expiration of the four-year statute of limitations, and pay any additional tax due, plus interest. With each request, the spun off corporation would have to provide the state treasurer with a list of all corporations, limited liability companies, and any other business entities that the spun off corporation controlled at the time of the restructuring transaction.

The term "spun off corporation" would be defined in the bill as an entity treated as a controlled corporation under Section 355 of the federal Internal Revenue Code. A controlled corporation includes a corporate subsidy created for the purpose of a restructuring transaction, a limited liability company, or an operational unit or division with business activities that were previously carried out as a part of the distributing corporation. The term "restructuring transaction" would mean a tax free distribution under Section 355, including transactions commonly referred to as spin offs, split ups, split offs, or type D reorganizations.

Sales and Use Taxes
(Senate Bill 544/House Bill 4744)

Apportionment. The bills would specify that property granted an exemption in either the sales tax or the use tax statute is exempt only to the extent that the property was used for exempt purposes. The bills also would specify that they intended to clarify that existing law as originally intended provides a prorated exemption. However, in the case of the exemption for certain telecommunications equipment (that taxed under Section 3a of the Use Tax Act), the provision that property would be exempt only to the extent it was used for exempt purposes would be effective beginning April 1, 1999. Prior to that there would be no apportionment.

Industrial Processing. The industrial processing exemption would be rewritten and expanded for property sold after March 30, 1999. The bills would provide a definition of the term "industrial processing" and a new definition of "industrial processor". Industrial processing would refer to the activity of converting or conditioning tangible personal property by changing the form, composition, quality, combination, or character of the property for ultimate sale at retail or for use in the manufacturing of a product to be ultimately sold at retail. The bill would specify that industrial processing begins when tangible personal property begins movement from raw materials storage to begin industrial processing and ends when finished goods first come to rest in finished goods inventory storage. The term "industrial processor" would refer to a person who performs the activity of converting or conditioning tangible personal property for ultimate sale at retail or use in the

manufacturing of a product to be ultimately sold at retail.

The bills would exempt sales of tangible personal property not only to an industrial processor but also to a person, whether or not an industrial processor, if the property was intended for ultimate use in and was used in industrial processing by an industrial processor and to a person who used the property to perform an industrial processing activity for or on behalf of an industrial processor.

The bill would specify that industrial processing would include production or assembly; research or experimental activities; engineering related to industrial processing; inspection, quality control, or testing at any time before materials or products first come to rest in finished goods inventory storage; planning, scheduling, supervision, or control of production or other exempt activities; design, construction, or maintenance of production or other exempt machinery, equipment and tooling; remanufacturing (overhauling, retrofitting, fabricating, or repairing a product or its component parts for ultimate sale at retail); processing of production scrap and waste up to the point it is stored for removal of the plant of origin; recycling of used materials for ultimate sale at retail or reuse; production material handling; and storage of in-process materials. Research or experimental activities would not include ordinary testing or inspection of materials or products for quality control; efficiency surveys; management surveys; market or consumer surveys; advertising or promotions; and research in connection with literacy, historical, or similar projects.

Also exempt would be a computer used in operating industrial processing equipment; equipment used in a computer-assisted manufacturing system; equipment used in a computer-assisted design or engineering system integral to an industrial process; a subunit or electronic assembly constituting a component in a computer-integrated industrial processing system; computer equipment used in connection with the computer-assisted production, storage, and transmission of data if the equipment would have been exempt had the data transfer been made using tapes, disks, CD-ROMS, or similar media by a company whose business includes publishing doctoral dissertations and information archiving, and that sells the majority of the company's products to exempt nonprofit organizations; and equipment used in the production of computer software that is offered for general sale to the public or software modified or adapted to the user's needs or equipment by the seller, only if the software is available for sale from a seller of software on an as-is basis or as an end product without modification or adaption. (Only the last item is not found in current statutes.)

Industrial processing would not include purchasing, receiving, or storage of raw materials; sales, distribution, warehousing, shipping, or advertising activities; administrative, accounting or personnel services; design, engineering, construction, or maintenance of real property and nonprocessing equipment; and plant security, fire prevention, or medical or hospital services.

Property eligible for an industrial processing exemption would include property that becomes an ingredient or component part of the finished product to be sold ultimately at retail; machinery, equipment, tools, dies, patterns, foundations for machinery or equipment, or other processing equipment used in an industrial processing activity and in their repair and maintenance; property consumed or destroyed or that loses its identity in an industrial processing activity; tangible personal property, not permanently affixed and not becoming a structural part of real estate, that becomes part of, or is used and consumed in installation and maintenance of, systems used for an industrial processing activity; fuel or energy used or consumed for an industrial processing activity; machinery, equipment, or materials used within a plant site or between plant sites operated by the same person for movement of tangible personal property in the process of production; and office equipment, including data processing equipment used for an industrial processing activity.

Property not eligible for an industrial processing exemption includes tangible personal property permanently affixed and becoming a structural part of real estate including building utility systems such as heating, air conditioning, ventilating, plumbing, lighting, and electrical distribution, to the point of the last transformer, switch, valve, or other device at which point usable power, water, gas, steam, or air is diverted from distribution circuits for use in industrial processing; office equipment, including data processing equipment used for nonindustrial processing purposes; office furniture or office supplies; and the industrial processor's own product or finished good that it uses or consumes for purposes other than industrial processing; tangible personal property used for receiving and storage of materials, supplies, parts, or components purchased by the user

or consumer; tangible personal property used for receiving or storage of natural resources extracted by the user or consumer; vehicles, including special bodies or attachments, required to display a vehicle permit or license plate to operate on public highways, except for a vehicle bearing a manufacturer's plate or a specially designed vehicle, together with parts, used to mix and agitate materials at a plant or job site in the concrete manufacturing process; tangible personal property used for the preparation of food or beverages by a retailer for ultimate sale at retail through its own locations; tangible personal property used or consumed for the preservation or maintenance of a finished good once it first comes to rest in finished goods inventory storage; returnable shipping containers or materials (with some exceptions); and tangible personal property used in the production of computer software originally designed for the exclusive use and special needs of the purchaser.

Extractive Operation Exemption. The bills would provide an exemption for the sale of tangible personal property to an extractive operator for use or consumption in extractive operations. Extractive operations would include the actual production of oil, gas, brine, or other natural resources. Eligible property would include casing pipe or drive pipe; tubing; well-pumping equipment; chemicals; explosives or acids used in fracturing, acidizing, or shooting wells; Christmas trees, derricks, or other wellhead equipment; treatment tanks; piping, valves, or pumps used before movement or transportation of the natural resource from the production area; chemicals or acids used in the treatment of crude oil, gas, brine, or other natural resources; and tangible personal property used or consumed in extracting the lithologic units necessary to process iron ore.

Property not eligible for an exemption would include tangible personal property consumed or used in the construction, alteration, improvement, or repair of buildings, storage tanks, and storage and housing facilities; tangible personal property consumed or used in transporting the product from the place of extraction, except for tangible personal property consumed or used in transporting extracted materials from the extraction site to the place where the extracted materials first come to rest in finished goods inventory storage; tangible personal property that is a product the extractive operator produces and that is consumed or used by the extractive operator for a purpose other than the manufacturing or producing of a product for ultimate sale; equipment, materials, and supplies used in exploring, prospecting, or drilling for oil, gas, brine, or other natural resources; equipment, materials, and supplies used in the storing, withdrawing, or distribution of oil, gas, or brine from a storage facility; and vehicles required to display a vehicle permit or license plate to operate on public highways.

The term "extractive operations" would refer to the activity of taking or extracting for resale ore, oil, gas, coal, timber, stone, gravel, clay, minerals, or other natural resource material. An extractive operation begins when contact is made with the actual type of natural raw product being recovered. Extractive operation includes all necessary processing operations before shipment from the place of extraction. Extractive operations includes all necessary processing operations and movement of the natural resource material until the point at which the natural raw product being recovered first comes to rest in finished goods inventory storage at the extraction site.

Rolling Stock. Senate Bill 544 would exempt a sale of rolling stock purchased by an interstate motor carrier or for rental or lease to an interstate motor carrier and used in interstate commerce. Until May 1, 1999, the General Sales Tax Act contained a partial exemption based on the amount of out-of-state usage of the rolling stock. The new exemption would be effective April 30, 1999. The term "rolling stock" refers to a qualified truck, a trailer designed to be drawn behind a qualified truck, and parts affixed to either a qualified truck or a trailer designed to be drawn behind a qualified truck. A "qualified truck" means a commercial motor vehicle power unit that has two axles and a gross vehicle weight rating in excess of 10,000 pounds or a commercial motor vehicle power unit that has three or more axles.

Bad Debt Deduction. House Bill 4744 would place a bad debt deduction into the Use Tax Act similar to that which already exists for the sales tax. (A recent court decision has already put such a bad debt deduction into the statute.) The bad debt deduction would be effective beginning March 30, 1995.

Hospital Property. Both bills would rewrite an exemption for contractors working on nonprofit hospitals for taxes levied after June 30, 1999. A longstanding exemption applies to the sale of tangible personal property to a person directly engaged in the business of constructing, altering, repairing, or improving real estate for others to the extent that the property is affixed to and made a structural part of a nonprofit hospital or a nonprofit housing entity

qualified as exempt under Section 15a of the State Housing Development Authority Act of 1966. The bills provide a new definition of "nonprofit hospital". It would refer to that portion of a building owned or operated by an entity licensed as a hospital under Part 215 of the Public Health Code and exempt under Section 501(c)(3) of the federal Internal Revenue Code; owned or operated by a governmental unit in which medical attention is provided; or owned or operated by an entity or entities exempt under Section 501(c)(2) or 501(c)(3) of the Internal Revenue Code in which medical attention is provided. The term would also apply to that portion of real property necessary and related to a building described above in which medical attention is provided and a county long-term medical care facility built after December 31, 1995. The term "nonprofit hospital" does not include a freestanding building or other real property of a nursing home or skilled nursing facility; a hospice; or a home for the aged. The term "medical attention" means that level of medical care in which a physician provides acute care or active treatment of medical, surgical, obstetrical, psychiatric, chronic, or rehabilitative conditions that require observation, diagnosis, and daily treatment by a physician.

For taxes levied after December 31, 1990 and before July 1, 1999, the sales and use taxes would not apply to a claimed exemption of tangible personal property used in the construction, alteration, repair, or improvement of the real estate for others to the extent the property was affixed to and made a structural part of a building of a nonprofit hospital, provided the facility in question was a portion of a building that was licensed under the health code and exempt under Section 501(c)(3) of the Internal Revenue Code; was owned or operated by a governmental unit and in which medical attention was provided; or was owned or operated by an entity or entities exempt under Section 501(c)(2) or (3) of the Internal Revenue Code and in which medical attention was provided. Other criteria would also have to be met. The claimed exemption would have to have been made in good faith; a binding contract would have to have been entered into for the construction, alteration, repair, or improvement of the real estate or the affixation to the building before July 1, 1999; and a claim for a refund would have to be filed no later than July 15, 1999. Also, the new provisions could not be applied to affect any final decision of a court.

BACKGROUND INFORMATION:

SBT Origins and Theory. The Single Business Tax Act was adopted as Public Act 228 of 1975 and took effect January 1, 1976. The SBT replaced the corporate income tax, the local property tax on business inventory, the corporate franchise tax, and several other smaller taxes, including the business intangibles tax and separate privilege fees on financial institutions, savings and loan companies, and domestic insurance companies. The new tax was proposed and enacted while the state was, according to one observer, "in the throes of one of its periodic fiscal crises, and . . . desperately in need of additional revenue." It was intended to be revenue neutral, except that the transition from the old set of taxes to a new single tax was scheduled so as to produce a one-time $180 million windfall to the state treasury for 1975-76. The SBT was also expected to be a more stable source of revenue than the corporate income tax. Although intended to be revenue neutral overall, the change to the tax system was expected to distribute the tax burden differently among different kinds of businesses. A November 1975 booklet from what was then the Michigan Department of Commerce said, "Utilities and other capital intensive firms and highly profitable businesses will generally have a lighter tax burden under the new law while professionals, less profitable firms and unincorporated businesses may find their tax burden somewhat increased." In the years since then, however, the tax has been greatly modified, often in response to complaints from those claiming to be disadvantaged or unduly burdened by the SBT.

(It should be noted that Michigan had another form of value-added tax, called the business activities tax or BAT from 1953 to 1967. It was repealed and replaced by the corporate income tax at about the same time the state's personal income tax was adopted.)

The single business tax was designed to be a value-added tax or business activity tax, and its architects described it as a tax paid by businesses for "benefits received" from government services rather than a tax based mainly on "ability to pay" like the corporate income tax. A value-added tax is typically described as a levy on the value a firm adds to goods and services purchased from other firms, with the value added by the handling or processing of the purchases

through the use of labor, machinery, buildings, and capital. A recent Department of Treasury publication notes that value added can be measured in two ways: 1) by measuring the difference between a firm's sales receipts and its purchases of materials and supplies from other firms, called the subtraction method; or 2) by adding together profits, compensation costs, interest paid, and depreciation, including direct taxes levied on these costs, referred to as the addition method. The Michigan SBT uses the second method. The SBT is also typically described as being a consumption-type value-added tax because it permits the cost of capital expenditures to be deducted from the tax base in the year that they are made. It is termed a "modified" consumption tax because it contains many variations from a pure consumption value-added tax, including exemptions, credits, and alternative methods of calculation. Some of these offer eligible firms the ability to pay taxes based on profits or on gross receipts (contrary to the theory of the value-added tax).

According to commentaries at the time and since, advocates emphasized the following advantages of the SBT over the old system: revenue stability, compared with the erratic corporate income tax; the promotion of capital investment and creation of new jobs; the simplification of administration; the fairer, more equal treatment of businesses; and the improved image of the state with multinational corporations. [These "advantages" appear somewhat ironic given that today, critics of the SBT indict the tax for lacking all of these qualities, except revenue stability.]

Computing the Tax. The SBT rate was lowered from the original 2.35 percent to 2.30 percent by Public Act 247 of 1994. The tax rate is applied to a firm's tax base, which generally speaking is composed of labor and other compensation costs, profits, depreciation, and interest paid. For multi-state firms, the tax base is apportioned using a three-factor formula, involving the proportion of payroll in the state to total payroll, the proportion of property in the state to total property, and the proportion of sales in the state to total sales. When the SBT was first enacted, each factor was treated equally. Over time, the sales factor increased to 40 percent for 1991 and 1992; 50 percent for 1993-1996; 80 percent for 1997 and 1998; and sales are currently weighted 90 percent with property and payroll weighted 5 percent each. Obviously, the increased reliance on sales provides an advantage to firms that sell outside of Michigan.

A deduction from the tax base, known as the capital acquisition deduction or CAD, is allowed for 100 percent of capital investments made in Michigan. For multi-state companies, the CAD is apportioned using the same formula (now 5-5-90) used in apportioning the tax base. Special provisions for certain retailers (notably the Michigan-based Meijer and K-Mart companies) allow them to use the CAD in effect prior to 1996, which permitted the deduction of investments made in any state multiplied by the apportionment factor.

In addition, the Single Business Tax Act has a number of exemptions, exclusions, credits, and alternative calculations. These include the following.

-- Farms are exempt from the tax.

-- Insurance companies use a tax base that is 25 percent of "adjusted receipts" as that term is defined in the act.

-- Firms with adjusted gross receipts below $250,000 do not have to file a return or pay the tax.

-- The statutory exemption permits the deduction of $45,000 from the tax base with an additional $12,000 per shareholder available (up to $48,000). The exemption is reduced by $2 for each $1 of modified business income over $45,000. Modified business income is adjusted business income plus compensation and director fees of shareholders, plus any loss carryovers. (This is also explained as allowing the deduction to any firm whose total of business income and shareholder compensation is below $67,500.)

-- The small business credit is available, up to 100 percent of tax liability, to firms whose gross receipts do not exceed $10 million and whose adjusted business income does not exceed $475,000, as long as no officer or owner receives more than $115,000 as compensation or as a share of business income. Businesses that qualify can use one of two methods of computing their SBT liability: 1) by claiming a credit derived by dividing adjusted business income by 45 percent of the tax base; or 2) by using as their tax liability 2 percent of adjusted business income.

-- An excess compensation deduction allows businesses whose compensation or labor costs are a high proportion of their tax base (in excess of 63 percent) reduce their tax base by up to 37 percent. For example, a firm whose compensation costs constituted 80 percent of the SBT base could reduce the base by 17 percent (80 minus 63).

-- The gross receipts reduction specifies that the tax base cannot exceed 50 percent of gross receipts. (Firms can calculate their tax based on 1.15 percent of gross receipts.)

-- Unincorporated businesses can claim a credit varying from 10 percent to 20 percent of SBT liability based on

business income: 20 percent if business income is $20,000 or less; 15 percent if business income is between $20,000 and $40,000; and 10 percent if business income is over $40,000.

-- A number of other credits are available, including credits granted by the Michigan Economic Growth Authority (MEGA), credits for firms in enterprise zones and similar programs, as well as credits for certain specified charitable contributions and for historical preservation expenditures.

Tax Payments. SBT revenues for fiscal year 1999-2000 were estimated at $2.48 billion. (Another $202 million is anticipated from insurance company retaliatory taxes and those revenues are sometimes added to the SBT, producing a business tax total of $2.682 billion.) All SBT revenue goes to the general fund. SBT revenues are expected to constitute 11.66 percent of all state taxes and account for about 27.4 percent of general fund revenues. The SBT contributes about 7.5 percent of total state revenues from all sources, including federal aid. (See the booklet State of Michigan Revenue Source and Distribution issued March 1999 by the House Fiscal Agency.) These estimates precede the enactment of the rate cut and other changes.

The Department of Treasury estimates that of the approximately 250,000 businesses in Michigan, fewer than 160,000 must file SBT returns and of those only 90,000 have any SBT liability. Figures from 1994-95 indicate that nearly 90 percent of total revenues came from fewer than 12 percent of taxpayers. In 1996, the largest 200 or so firms in the state paid over 30 percent of total SBT revenues.

Useful sources on the Single Business Tax Act include two booklets analyzing the tax from the Department of Treasury, dated August 1994 and March 1998; the Michigan Taxpayer's Guide, produced by the Legislative Service Bureau; and three papers produced for the Fiscal 101 seminars sponsored by the two legislative fiscal agencies and Wayne State University by Robert Kleine of Public Sector Consultants; Howard Heideman of the Office of Revenue and Tax Analysis in the Department of Treasury; and James H. Novis of Honigman Miller Schwartz and Cohn. There are also many useful older documents, including a chapter by Robin Barlow and Jack S. Connell, Jr. in Michigan's Fiscal and Economic Structure, edited by Harvey Brazer and published in 1982; a 1978 report by Kleine from the Advisory Commission on Intergovernmental Relations; and 1984 report to the House of Representatives by Douglas Drake.

FISCAL IMPLICATIONS:

According to Department of Treasury estimates of 6-3-99 provided by the House Fiscal Agency, the package of bills would produce in fiscal year 1998-99 a $49.3 million increase to the general fund and a $94.1 million increase to the school aid fund. In fiscal year 1999-2000, the bills would result in a reduction in general fund revenue of $194.6 million and an increase in school aid fund revenues of $7.4 million. These figures represent the effect the bills would have on the consensus revenue estimates made prior to the tax package being proposed. Those estimates anticipated the state losing revenue as a result of the Michigan Bell case (described earlier). The tax proposal would, in a sense, "fix" the problem resulting from the court decision and offset the anticipated lost revenues. This explains the revenue increases from the package.

The effects of the various tax changes are as follows, according to information from the Office of Revenue and Tax Analysis dated 6-3-99.

• 1998-99 General Fund/General Purpose revenues: A loss of $87.6 million from the SBT rate cut; a loss of $1.9 million from the change of treatment of rolling stock in the sale and use taxes; and a gain of $137.9 million from the so-called Michigan Bell fix (apportionment of the industrial processing exemption).

• 1999-2000 General Fund/General Purpose revenues: A loss of $213.8 million from the SBT rate cut; a loss of $13.5 million from the expanded industrial processing exemption in the sales and use tax acts; and a loss of $2.5 million from the rolling stock exemptions.

• 1998-99 School Aid Fund revenues: A loss of $3.1 million from rolling stock exemption in the sales tax and a gain of $97.2 million from the Michigan Bell fix.

• 1999-2000 School Aid Fund revenues: A loss of $9.5 million from industrial processing changes; a loss of $7.9 million from rolling stock exemptions; and a gain of $24.8 million from the Michigan Bell fix.

ARGUMENTS:

For:

The gradual phaseout of the SBT promises businesses their taxes will be reduced year after year. It promises that at least some portion of future state revenue growth will go towards business tax relief. (Just as other recently enacted legislation will ensure that some portion of future revenue growth will go towards reduced personal income tax rates.) This will make Michigan and Michigan businesses more competitive and will maintain and attract high paying jobs. Cutting business taxes means cutting the cost of doing business and providing jobs. Phasing out and eventually eliminating the SBT will reduce a barrier to attracting new investment in the state. Michigan is the only state with this kind of tax. For years, public policy analysts thought other states would follow Michigan's lead and adopt value-added taxes, but they have not. Economic development strategists say the very uniqueness and unfamiliarity of the tax can be an impediment in selling the state to new investors.

The tax has been modified many times since its introduction, typically in response to requests from businesses seeking special treatment due to special circumstances, to complaints from businesses who felt they were being treated unfairly, or to court decisions in cases brought by disgruntled businesses. But changes to the tax have made it more complex. Some would say the tax is becoming evermore incoherent and arbitrary as it departs bit by bit from the original underlying theories. In announcing the SBT phaseout, Governor Engler said, "We will no longer try to fix what can't be fixed." This proposal ends the tinkering with an unpopular, unpalatable tax, a tax under constant threat of litigation, and simply phases it out over time.

The phaseout is a responsible approach that protects the state budget from the sudden shock of instant repeal or the prolonged uncertainty that would accompany continual debate over how to modify or replace the SBT. Further, it contains a safety valve provision that would halt rate decreases during serious budget difficulties.

When businesses are taxed, those taxes either go into the cost of goods and services to consumers, come out of the wage packets of workers, or reduce profits that otherwise could be distributed to shareholders or reinvested, for example in research and development activities. This is what is meant by the claim that "businesses don't pay taxes but just collect them." Cutting taxes for businesses that now face SBT liability will have a positive overall effect on business activity and the state economy. As a result, all will eventually benefit, including consumers, workers, and the smaller non-SBT paying businesses, whose fortunes are often tied to those of larger companies.

Moreover, it is not fair to say the proposal will eliminate business taxes. Besides the fact that the SBT is to be phased out over many years (and not eliminated immediately), businesses in the state pay substantial amounts in real property taxes (not having received cuts under Proposal A as large as individuals received), personal property taxes (which only businesses pay), and sales and use taxes, as well as a wide variety of fees. This will be just one of many tax cuts initiated in the 1990's. Individuals, as opposed to businesses, have been the beneficiaries of over three-quarters of the cumulative tax cuts this decade, according to administration figures.

Response:

If the SBT is such an odious, onerous tax, why leave it in place for 20-plus years? Why not speed up the phaseout and/or find some suitable alternative source of revenue?

For:

In addition to the SBT rate reduction and phaseout, the package contains a number of other beneficial business tax changes. These include the following.

** The capital acquisition deduction has a checkered, litigious history. Under this proposal, it will be replaced by an investment tax credit, similar to the kind of credit found in many other states. The credit will be for investments made in the state. Some tax specialists doubt the current apportioned CAD can withstand a lawsuit on constitutional grounds because of its different treatment of investments inside and outside the state by multistate companies. Rather than face the uncertainty and confusion that accompanies the CAD, it is better to replace it with the more commonplace investment tax credit. This will provide strong incentives for businesses to invest in Michigan and greater certainty in tax planning.

** New provisions will make foreign companies doing business in Michigan subject to the SBT for some of their activities even if they do not file a federal corporate income tax return. The principle behind this is to prevent foreign firms from enjoying an unfair advantage over Michigan-based or out-of-state U.S. firms doing business in the state.

** Equipment used in industrial processing is exempt from the sales and use taxes. Some equipment is used both for industrial processing and for other purposes and the Department of Treasury's longstanding practice has been to apportion the exemption for equipment used for exempt and non-exempt purposes. A recent court decision on the treatment of telecommunications equipment said there was no statutory basis for the practice of apportioning exemptions and prohibited it. Instead, the court allowed a full exemption when equipment was first used for a tax-exempt purpose and continued to be used substantially for tax exempt purposes. The decision has the potential effect, generally speaking, of expanding the industrial processing exemption for all kinds of businesses. This proposal reinstates the practice retroactively, thus relieving the state from having to pay large amounts of sales and use tax refunds and avoiding the loss of future revenue. (The proposal applies only prospectively to telecommunications companies, however.)

** The proposal would clarify and broaden the industrial processing exemption. Proponents of the package say it would re-define when industrial processing begins and ends; extend the exemption to certain third parties working on behalf of industrial processors, including those engaged in research and experimental activities and product quality activities; and expand the kind of waste removal and recycling activities that qualify for the exemption.

** The SBT contains a disincentive now for companies to engage in restructuring or spin-offs because such organizational changes can result in higher taxes. The industrial restructuring deduction provides for a "hold harmless" period of up to seven years for such changes by excluding from the tax base calculation sales by the spun off company to a company it had previously been affiliated with. This deduction will only be available to companies making sizeable future investments in the state.

** A recent court decision said the Use Tax Act should be read as if it contained a bad debt deduction parallel to that which has long existed in the General Sales Tax Act. House Bill 4744 ratifies that decision and puts such a provision in the statute.

** Two issues that have previously been part of other legislation are incorporated into this package, one that would extend and expand the sales and use tax exemption for large trucks, trailers, parts (known as rolling stock) used in interstate commerce; and one that would clarify the term "hospital" for purpose of administering an existing exemption for contractors doing construction work for nonprofit hospitals.

Against:

This proposal benefits large, wealthy corporations at the expense of the rest of the state's taxpayers. Only about 35 percent of the state's businesses pay the SBT. This means about 65 percent of the state's businesses get no direct relief from this proposal. Critics say that about 75 percent of SBT revenues come from 5 percent of the state's firms. It is this 5 percent that will gain the greatest benefit from this proposal. All businesses pay the personal property tax, another complicated onerous tax. Why not concentrate relief there? Or, why not target relief at small business by increasing the gross receipts threshold to, say, one million dollars, so that more businesses are exempt from taxation altogether? Or, why not remove health care costs from the compensation portion of the SBT tax base as an incentive for companies to provide or retain or expand health care coverage for employees? There are a number of proposals preferable to the straight 23-year phaseout of the SBT. It is unfortunate that the legislature did not take the time to evaluate the various proposals one against another.

Furthermore, it should be noted that the SBT proposal will actually increase the tax liability of some companies over the short run because of the switch from an apportioned capital acquisitions deduction to a non-apportioned investment tax credit. This will work to the disadvantage, generally speaking, of firms that operate entirely or mostly in the state of Michigan. The proposal will also increase taxes for large retailers (notably Meijer and K-Mart) who have only recently begun to enjoy special treatment under the SBT for capital investments. With the switch from a CAD to an ITC, these special provisions will be lost. Telecommunications companies have also complained about their treatment, arguing that their taxes will increase due to the apportionment of exemptions for central office equipment and the replacement of the CAD with the ITC. Reductions in the SBT rate will take several years to offset the increases, they say.

There is also concern about the impact of the provisions taxing foreign companies. The original proposal outraged Canadian manufacturers, particularly auto parts manufacturers, and some critics warned of a trade war. While the provisions relating to foreign companies have been modified as a result, their effects still will bear watching.

Against:
With the large surpluses anticipated for state government, tax relief should be targeted towards individuals not businesses. Michigan's economic development record in recent years appears to be outstanding; the state's tax structure does not appear to be having a negative effect on Michigan's ability to compete with other states for new business and job growth. On the other hand, many of the state's families are financially squeezed. Eliminating the SBT will mean that a disproportionate amount of the tax burden will fall on individual taxpayers. There are many alternative ways of addressing the current budget surpluses. House Democrats, for example, have proposed a $50 per person rebate, which would benefit all individuals equally. Some people advocate the creation of a state credit to piggyback on the federal earned income tax credit; that would benefit the working poor. But however tax relief is provided, it should be aimed at working families and not at the state's largest and wealthiest corporations.

Against:
Defenders of the SBT would say that the concept of the value-added tax is a good one and that the tax ought to be preserved and reformed. While the tax has become extremely complicated, that is in part because of the many changes made in response to its critics. Many of these changes (and criticisms) were unwarranted and based on a misunderstanding of the theory behind the tax. It is exasperating that attempts to placate SBT critics and improve public perceptions of the tax lead inevitably to complaints that the subsequent modifications have made the tax too complicated. A return to a simpler, widely applied value-added tax with a low rate and few exceptions and exclusions would be preferable to a phaseout and repeal. After all, businesses ought to help pay for the government services from which they, along with others, benefit. Business benefits from spending on transportation, education, and the legal system, among many other services, and ought to contribute to their support.

Against:
Is it wise to project tax cuts so far into the future? What happens when there is an economic downturn, when tax revenues are not so robust? Will the state be able to meet its obligations and the needs of its residents if it forgoes billions of dollars of revenue over the next two decades? Wouldn't it be better to give today's tax cuts a shorter horizon and let future legislatures determine how much revenue is needed based on assessments made at the time? It is difficult to imagine that the state can eliminate one of its major revenue sources, even if gradually, and still be able to fully fund state government operations.

Response:
This proposal, like the earlier income tax cuts, represents a statement of priorities and locks in a policy of returning a portion of future revenue growth to taxpayers. It represents a commitment to ongoing tax relief. Nothing in the proposal prevents future legislatures from taking the actions they determine necessary regarding taxing and spending.

Analyst: C. Couch

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.