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SFA BILL ANALYSIS

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Senate Bill 544 (as enrolled) **PUBLIC ACT 116 of 1999**
House Bill 4744 (as enrolled) **PUBLIC ACT 117 of 1999**
House Bill 4745 (as enrolled) **PUBLIC ACT 115 of 1999**
House Bill 4586 (as enrolled) **PUBLIC ACT 70 of 1999**
Sponsor: Senator Mike Rogers (Senate Bill 544)
Representative Nancy Cassis (House Bill 4744 & 4745)
Representative Rick Johnson (House Bill 4586)
Senate Committee: Finance
House Committee: Tax Policy

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RATIONALE

The State's primary tax on business is prescribed in the Single Business Tax (SBT) Act, which has been in effect since 1976. The tax replaced seven business taxes that were in effect at the time. It was, and has remained, unique among the states in terms of its approach toward business taxation. The SBT is considered a value-added tax because it imposes tax on value added to products at each step of production and distribution; that is, it attempts to measure a firm's business activity, and tax that activity, rather than simply tax a firm's profits or receipts as is common in other states.

Even though the SBT has been modified substantially over the years, since its inception it has generated widespread complaints from members of the business community. Many have long contended that it is unfair to tax a business on activity rather than profit, and that including such expenses as health care, other benefits, and wages in a business's tax base discourages hiring new employees. Others have complained that the tax causes a high tax burden for Michigan businesses compared with the taxation of businesses in other states. Some people believe that further modifications to the SBT Act would never completely remove the problems that it has caused for business, and the tax therefore should be entirely phased out.

Further, although the Act's capital acquisition deduction (CAD) was designed to provide tax relief to business, it too has been subject to challenges and changes. Prior to 1995, the CAD allowed a business to calculate the total cost of all its purchases of tangible assets, both in and out of Michigan during the tax year, and then apportion this amount between Michigan and elsewhere using the same factors used to apportion its tax base (property, payroll, and sales). The apportioned amount was then subtracted from the firm's Michigan tax base to arrive at its adjusted tax base. Under this provision, it was possible for a multistate company not to make any new purchases of tangible assets in Michigan but still receive a CAD. It was also possible for a multistate business that made substantial new physical investments in Michigan to receive a CAD that was less than its total investments in Michigan. To provide an incentive for investment in the State, the Act was amended to make the CAD available only for capital investments made in Michigan. The CAD has been the subject of several court challenges through the years by out-of-State firms that claimed that the SBT unfairly burdened them compared with in-State firms, and thus violated the Commerce Clause of the U.S. Constitution. Reportedly, the new CAD has generated new challenges in court. It has been suggested that the CAD be eliminated in favor of an investment tax credit that is used in several other states.

In another matter involving business taxation, the Michigan Supreme Court recently let stand a Michigan Court of Appeals decision (*Michigan Bell Telephone* v *Department of Treasury*, 229 Mich App229 (1998)) that concluded that the Use Tax Act did not require a taxpayer to apportion the use of equipment or other purchases between exempt and nonexempt uses. The Court of Appeals ruled that Michigan Bell was entitled to a full use tax exemption for purchases of equipment, even though a portion of the equipment was used for nonexempt purposes. For many years, the Department has required businesses remitting use taxes and sales taxes to apportion the applicable tax between exempt and nonexempt uses. It has been suggested that the sales and use tax statutes be amended to authorize apportionment and thus codify what has been the Department's long-standing policy.

CONTENT

House Bill 4745 amended the Single Business

Tax Act to reduce the tax rate by .1% per year under certain conditions; repeal the tax if the tax rate is reduced to 0.0%; replace the capital acquisition deduction with an investment tax credit; prescribe the tax base of a foreign person; and allow a corporation that restructured after 1998, and no longer is a member of an affiliated group, to calculate its apportionment sales factor for five years under certain circumstances. Senate Bill 544 amended the General Sales Tax Act and House Bill 4744 amended the Use Tax Act to specify that exemptions allowed under the Acts are to be apportioned based upon exempt use versus total use; revise and expand the industrial processing exemption; prescribe the application of the taxes to telecommunications equipment; revise the sales and use tax exemption for nonprofit hospitals; create an extracting operations exemption; create a bad debt deduction; provide for the direct payment of the use tax to the Department of Treasury; and expand and extend the sales tax exemption for rolling stock. House Bill 4586 amended the Use Tax Act to reinstate the use tax exemption for rolling stock.

The bills were tie-barred to each other.

House Bill 4745

SBT Reduction

Currently, the SBT rate is 2.3% of the adjusted tax base of every person with business activity in the State. The bill provides that beginning January 1, 1999, the tax rate will be reduced by .1% each January 1 if the Comprehensive Annual Financial Report for a State fiscal year (published pursuant to the Management and Budget Act) reports an ending balance of more than $250 million in the Countercyclical Budget and Economic Stabilization Fund for that fiscal year. The Department of Treasury must annualize the rate as necessary, and the applicable annualized rate will be imposed.

Investment Tax Credit

Currently, the CAD generally allows a taxpayer, after allocation or apportionment, to deduct the amount paid or accrued in a taxable year for tangible assets that are (or under the Internal Revenue Code will become) eligible for depreciation for Federal income tax purposes, provided that the assets are located in Michigan for use in a business activity in this State. Under the bill, the current provisions apply to tax years beginning before January 1, 2000; for tax years after 1999, a taxpayer may claim an investment tax credit (ITC) for a percentage of the costs paid or accrued in a taxable year for tangible assets physically located in Michigan.

The bill contains language that prescribes the calculation of the investment tax credit. Essentially the credit will equal a percentage of the amount a firm invests in tangible assets in Michigan, for a tax year beginning after December 31, 1999; for subsequent tax years the percentage will be reduced each year the tax rate is reduced. The ITC will be calculated as follows:

$$\left(\frac{\text{Current Year Tax Rate} \times .85\%}{2.3\%}\right) \times ([A+B+C] - [D+E+F])$$

Under the formula, A, B, and C represent the costs paid or accrued in a taxable year for tangible assets and mobile tangible assets as provided in the bill; D, E, and F represent the gross proceeds of the sale or other disposition of assets A, B, and C, and the transfer out of State of those assets that are not mobile tangible assets.

If the ITC for a tax year is determined to be negative, the absolute value of the amount must be added to the taxpayer's tax liability. If the credit for a tax year and any unused carryforward of the credit exceed the tax liability of the taxpayer for the tax year, the excess may not be refunded, but may be carried forward as an offset to the tax liability in nine subsequent tax years or until the excess credit is used up, whichever occurs first. The ITC must be taken before any other credit under the Act. The credits under other provisions of the Act must be calculated using the tax liability after the calculation of the investment tax credit and, to the extent provided by law, after the calculation of credits under other provisions of the Act.

Under the Act, if a taxpayer's adjusted tax base is greater than 50% of gross receipts plus adjustments, the adjusted tax base may be reduced by the excess, at the option of the taxpayer. The bill provides that a taxpayer who chooses this option may not claim the investment tax credit.

Further, the Act allows a taxpayer to compute the percentage of tax base attributable to compensation; if the percentage exceeds 63%, the taxpayer may reduce the adjusted tax base by the amount that exceeds 63%. The bill provides that if a taxpayer makes this reduction, then the taxpayer's investment tax credit must be reduced by a percentage, determined by multiplying the percentage reduction to the adjusted tax base claimed by the taxpayer by the result of the following equation:

$$\frac{A}{(A/2.3\%) \times .85\%}$$

where A = current year tax rate

The Act provides penalties for underpayment of estimated SBT liability. The bill provides that a penalty may not be assessed for a taxpayer's first tax year after 1999 if the taxpayer claims an investment tax credit for the first time on the annual return, and

a penalty would not have applied if the taxpayer had claimed a CAD on that return.

Foreign Entities

The bill specifies that for tax years beginning after 1999, the tax base of a foreign person (except an insurer) includes the sum of "business income" and the adjustments allowed under the Act that are related to United States business activity, whether or not the foreign person is subject to taxation under the Internal Revenue Code (IRC). The bill defines "foreign person" as either an individual who is not a United States resident, whether or not the individual is subject to taxation under the IRC; or a person formed under the laws of a foreign country or a political subdivision of a foreign country, whether or not the person is subject to taxation under the IRC. "Business income", for a foreign person, means gross income attributable to the taxpayer's U.S. business activity and gross income derived from sources within the United States, minus the deductions allowed under the IRC that are related to that gross income. Gross income includes the proceeds from sales shipped or delivered to any purchaser within the United States and for which title transfers within the United States; proceeds from services performed within the United States; and a pro rata proportion of the proceeds from services performed both inside and outside the United States, based on cost of performance. "Compensation" means, for a foreign person, the daily compensation paid to each employee, officer, and director of the foreign person multiplied by the number of days that the employee, officer, or director has physical contact with the United States in the tax year.

The bill requires a foreign person to calculate business income under the bill's provisions. The tax base of a foreign person is subject to all adjustments and other provisions under the SBT Act, unless otherwise provided. A foreign person must calculate compensation by reporting total compensation paid to employees, officers, and directors for services performed in the United States.

The SBT Act requires a multistate firm doing business in Michigan, whether or not headquartered here, to apportion its tax base by determining how much of its business activity is attributable to Michigan. This requires the firm to calculate the ratio of its property, payroll, and sales in Michigan to its entire property, payroll, and sales, and apply this ratio to its nationwide tax base, resulting in its apportioned tax base. The Act prescribes the method that must be used to calculate the property, sales, and payroll factors. The bill provides that for a foreign person, the property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented in Michigan during the tax year by the taxpayer, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented in the United States during the tax year. The payroll factor is a fraction, the numerator of which is the total wages paid for services performed in Michigan during the tax year by the taxpayer, and the denominator of which is the total wages paid for services performed in the United States during the tax year by the taxpayer. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Michigan during the tax year, and the denominator of which is the total sales of the taxpayer in the United States during the year.

Restructuring

The bill allows a "spun off corporation" to elect to calculate its sales factor for a period of five years under conditions specified in the bill, including the corporation's commitment to the State that it will make a capital investment in the State of at least $500 million within five years. A two-year extension may be obtained for an additional commitment of $200 million in the following two years. (Essentially, this allows a parent corporation, and another corporation that split off from it, to be held harmless for sales between the entities.)

The bill defines "spun off corporation" as an entity treated as a controlled corporation under Section 355 of the IRC. A controlled corporation includes a corporate subsidiary 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. "Restructuring transaction" means a tax free distribution under Section 355 of the IRC, and includes tax free transactions that are commonly referred to as spin offs, split ups, split offs, or type D reorganizations.

The bill provides that a qualified and approved spun off corporation calculates its apportioned sales factor as provided under the SBT Act, except that total sales do not include sales to a purchaser that was a member of a Michigan affiliated group that had included the seller in the filing of a combined or consolidated annual SBT return but, as a result of the restructuring transaction, ceased to include the seller. Further, a purchaser in Michigan does not include a person who purchases from a seller that was included in the purchaser's combined or consolidated annual SBT return but, as a result of a restructuring transaction, ceased to be included in the purchaser's combined or consolidated annual return. (Under the Act, sales of tangible personal property are considered to be sales in this State if the property is shipped or delivered to any purchaser within Michigan.)

At the end of the fifth year following a restructuring transaction, if a spun off corporation that elected to calculate its sales factor under the bill has failed to pay or accrue the $500 million capital investment, the spun off corporation must file amended annual

returns for each of the years the corporation calculated its sales factor under the bill regardless of the applicable statute of limitations under the revenue Act, and pay any additional tax plus interest based on the sales factor as calculated under the Act. Interest must be calculated from the due date of the original return. At the end of the seventh tax year following the restructuring transaction, if the corporation has failed to pay or accrue the additional $200 million capital investment, it must file amended annual returns for the sixth and seventh tax years and pay any additional tax plus interest, calculated from the due date of the original return.

A spun off corporation may elect to calculate its sales factor for five years under the bill's provisions if the following criteria are met:

- -- The spun off corporation was included in a combined or consolidated SBT return for the tax year immediately preceding the restructuring transaction.
- -- As a result of the restructuring transaction that occurred on or after January 1, 1999, the spun off corporation ceased to be included in the combined or consolidated annual return and, without regard to the bill, would have had an increased SBT liability for the tax year in which the election is made.

In addition, by the due date for filing its first annual return following the restructuring transaction, the spun off corporation must request, in writing, approval from the State Treasurer for the election. The State Treasurer must approve the request. The request must include a statement that the spun off corporation qualifies for the election; 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; and a commitment by the spun off corporation to invest at least $500 million of capital investment in Michigan within five years, beginning with the first tax year following the tax year in which the restructuring transaction was completed.

Before the end of the sixth year following the restructuring transaction, and if the spun off corporation is not required to file amended returns, the spun off corporation must request, in writing, approval from the State Treasurer for the election to be extended for two years. The State Treasurer must approve the request. The request must include a commitment by the spun off corporation to invest at least $200 million of capital investment in Michigan within the next two years, beginning with the sixth tax year following the tax year in which the restructuring transaction was completed.

Senate Bill 544 and House Bill 4744

Apportionment

The bills specify that the property or services that are exempt under the General Sales Tax Act or the Use Tax Act are exempt only to the extent that the property or services are used for the exempt purpose, if one is stated in the Act. The exemption is limited to the percentage of exempt use to total use determined by a reasonable formula or method approved by the Department.

Each bill states the following: "This amendatory act clarifies that existing law as originally intended provides for a prorated exemption. This amendatory act takes effect for all periods beginning March 31, 1995 and all tax years that are open under the statute of limitations provided in section 27a of 1941 PA 122" (the revenue Act). With the exception of telecommunications equipment taxed under the Use Tax Act, neither the sales tax nor the use tax applies to the sale of tangible personal property or to the price of property or services, to the extent the property or services is used, stored, or consumed for exempt purposes. For telecommunications equipment, the bills provide, "This amendatory act clarifies that for periods before April 1, 1999, the tax shall not be apportioned and for periods beginning April 1, 1999, the tax shall be apportioned".

Industrial Processing Exemption

The Acts contain an exemption for personal property sold to an industrial processor for use or consumption in industrial processing. The bills provide that for property sold to an industrial processor after March 30, 1995, and before March 31, 1999, the property is exempt only to the extent that it is used for the exempt purposes stated in the Act. The exemption is limited to the percentage of exempt use to total use determined by a reasonable formula or method approved by the Department.

The bills provide for a revised and expanded industrial processing exemption for personal property sold after March 30, 1999. The tax does not apply to property sold to an industrial processor for use or consumption in industrial processing; a person, whether or not the person is an industrial processor, if the tangible personal property is intended for ultimate use in and is used in industrial processing by an industrial processor; a person, whether or not the person is an industrial processor, if the tangible personal property is used by that person to perform an industrial processing activity for or on behalf of an industrial processor; or a person, whether or not the person is an industrial processor, if the tangible personal property is one of the following:

- -- 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 comprising 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 its products to certain tax-exempt nonprofit organizations.
- -- 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 adaptation.

Under the industrial processing exemption, property is exempt only to the extent that it is used for the exempt purpose stated in the bills. The exemption is limited to the percentage of exempt use to total use determined by a reasonable formula or method approved by the Department.

The bills define "industrial processing" as 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. 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 inventory storage.

Industrial processing includes the following activities:

- -- Production or assembly.
- -- Engineering related to industrial processing.
- -- Inspection, quality control, or testing to determine whether particular units of materials or products or processes conform to specified parameters 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.
- -- Processing of production scrap and waste up to the point it is stored for removal from the plant of origin.
- -- Recycling of used materials for ultimate sale at retail or reuse.
- -- Production material handling.
- -- Storage of in-process materials.

Industrial processing also includes "research or experimental activities", that is, activities incident to the development, discovery, or modification of a product or a product related process, including activity necessary for a product to satisfy a government standard or to receive government approval. Research or experimental activity does not include ordinary testing or inspection of materials or products for quality control purposes; efficiency surveys; management surveys; market or consumer surveys; advertising or promotions; or research in connection with literacy, historical, or similar projects.

Property that is eligible for an industrial processing exemption includes the following:

- -- 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 the repair and maintenance of the machinery, equipment, etc.
- -- Property that is 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 a 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.
- -- Office equipment, including data processing equipment, used for an industrial processing activity.

Property that is not be eligible for an industrial processing exemption includes the following:

- -- 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.
- -- An 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 storing materials, supplies, parts, or components purchased by the user or consumer.
- -- Tangible personal property used for receiving or storing 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.
- -- Tangible personal property used in the production of computer software originally designed for the exclusive use and special needs of the purchaser.
- -- Returnable shipping containers or materials, except those 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.

Industrial processing does not include purchasing, receiving, or storing 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; or plant security, fire prevention, or medical or hospital services.

Telecommunications Equipment

Both the General Sales Tax Act and the Use Tax Act exempt the purchase of certain machinery and equipment for use or consumption in the rendering of services involving intrastate telephone services, telegraph, leased wire, or other similar communications. The bills provide that, beginning April 1, 1999, the property is exempt only to the extent that it is used for the exempt purposes stated in the bills. Further, the bills provide that there is an irrebuttable presumption that 90% of total use is for exempt purposes. This presumption will be in effect until April 1, 2006, at which time the Department must review and redetermine the presumption using nonexempt and exempt user information for the previous 12-month period. That redetermined irrebuttable presumption will be in effect for the following seven years. The presumption must be reviewed and redetermined every seven years after April 1, 2006, and applied to the following seven years.

Extractive Exemption

The bills exempt from the sales and use taxes property sold to an extractive operator for use or consumption in "extractive operations". The property is exempt only to the extent that it is used for the exempt purposes stated in the bills. The exemption is limited to the percentage of exempt use to total use determined by a reasonable formula or method approved by the Department.

The bills provide that an extractive operator is a person who, either directly or by contract, performs extractive operations. The bills define "extractive operations" as 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 operations include all necessary processing operations before shipment from the place of extraction; and 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.

Further, extractive operations include the actual production of oil, gas, brine, or other natural resources. Property eligible for the exemption includes 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; tangible personal property used or consumed in depositing tailings from hard rock mining processing; and tangible personal property used or consumed in extracting the lithologic units necessary to process iron ore.

The extractive operations exemption does not include the following:

- -- Tangible personal property consumed or used in the construction, alteration, improvement, or repair of buildings, storage tanks, or storage and housing facilities.
- -- Tangible personal property consumed or used

in transporting the product from the place of extraction, except for the property consumed or used in transporting extracted materials from the extraction site to the place where the 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 operator for a purpose other than the manufacturing or producing of a product for ultimate sale. The extractor must account for and remit the tax to the State based upon the product's fair market value.
-- Equipment, materials, and supplies used in exploring, prospecting, or drilling for oil, gas, brine, or other natural resources, or used in storing, withdrawing, or distributing oil, gas, or brine from a storage facility.
-- Vehicles, including special bodies or attachments, required to display a vehicle permit or license plate to operate on public highways.

Nonprofit Hospital Exemption

The bills revised the existing exemption for property used in the construction or alteration of a "nonprofit hospital" or nonprofit housing entity. Under the Acts, an exemption is allowed for property purchased by a person engaged in the business of constructing, altering, repairing, or improving real estate for others to the extent the property is affixed to and made a structural part of the real estate of a nonprofit hospital or a nonprofit housing entity (qualified as exempt pursuant to the State Housing Development Authority Act).

Previously, the Acts specified that a nonprofit hospital or nonprofit housing included only the property of a nonprofit hospital or the homes or dwelling places constructed by a nonprofit housing entity, whose income or property did not inure to the benefit of an individual, private stockholder, or other private person. For taxes assessed after December 31, 1990, and before January 1, 1996, "hospital" included an entity that: was a separately organized entity, or a group of entities sufficiently related to be considered a single employer for purposes of the IRC, whose primary purpose was to provide medical, obstetrical, psychiatric, or surgical care or nursing, including care provided by skilled nurses in a long-term care facility; and, before January 1, 1996, initiated an appeal of taxes on tangible personal property used to construct a facility after 1990.

The bills retain the exemption, but specify that an exemption may not be granted for any portion of property that otherwise qualifies for an exemption under the bills, if income or a benefit inures directly or indirectly to an individual, private stockholder, or other private person from the independent or nonessential operation of that portion of property. The bills define "nonprofit hospital" as one of the following:

-- That portion of a building that 1) is owned or operated by an entity exempt under Section 501(c)(3) of the IRC, that is licensed as a hospital under the Public Health Code; 2) is owned or operated by a governmental unit in which "medical attention" is provided; or 3) is owned or operated by an entity or entities exempt under Section 501(c)(2) or (3) of the IRC, in which medical attention is provided.
-- That portion of real property necessary and related to a building (described above) in which medical attention is provided.
-- A county long-term care facility built after 1995.

A nonprofit hospital does not include a freestanding building or other real property of a licensed nursing home, skilled nursing facility, hospice, or home for the aged.

Under the bills, "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 the observation, diagnosis, and daily treatment by a physician.

In addition, the bills provide that for taxes levied after 1990 and before July 1, 1999, the taxes do not apply to a claimed exemption of tangible personal property used in the construction, alteration, repair, or improvement of the real estate or affixed to and made a structural part of a building of a nonprofit hospital provided the following criteria have been met:

-- A binding contract had been entered into for the construction, alteration, repair, or improvement of the real estate or the affixation to the building before July 1, 1999.
-- The claimed exemption was made in good faith.
-- The property is a licensed hospital building owned or operated by an entity exempt under Section 501(c)(3) of the IRC; a building owned or operated by a governmental unit in which medical attention is provided; or a building owned or operated by an entity or entities exempt under 501(c)(2) or (3) of the IRC, in which medical attention is provided.

A claim for a refund for an exemption under these provisions had to be filed before July 16, 1999. Approved refunds will be paid without interest. The provisions of this exemption may not be applied to affect any final decision of a court.

Direct Remittance

House Bill 4744 allows the Revenue Commissioner, at his or her discretion, to authorize a person to assume the obligation of self-accruing and remitting use tax due on purchases or leases directly to the Department under a direct payment authorization, if the following conditions are met:

-- The authorization is to be used for the purchase or lease of tangible personal property or services.
-- The authorization is necessary because it is impractical at the time of acquisition to determine the manner in which the property or services will be used, or it will facilitate improved compliance with the State's tax laws.
-- The person requesting authorization for direct payment maintains accurate and complete records of all purchases or leases and uses of tangible personal property or services purchased pursuant to the authorization, in a form acceptable to the Department.

The Commissioner also has the authority to identify items that are not eligible for a direct payment authorization.

Bad Debt Deduction

Under House Bill 4744, beginning March 30, 1995, in computing the amount of use tax levied for any month, a seller may deduct the amount of bad debts from his or her gross sales, rentals, or services used for the computation of the tax. The amount of gross sales, rentals, or services deducted must be charged off as uncollectible on the books of the seller. If the business consists of taxable and nontaxable transactions, the deduction equals the full amount of the bad debt if the bad debt is documented as a taxable transaction in the seller's records. If documentation is not available, the maximum deduction from gross sales, rentals, or services for any bad debt equals the amount of the bad debt multiplied by the quotient resulting from dividing the sales, rentals, or services taxed during the preceding calendar year by all sales, rentals, or services during that year, whether or not taxed. If a consumer or other person pays all or part of a bad debt with respect to which a seller claimed a deduction, the seller will be liable for the amount of taxes deducted in connection with that portion of the debt for which payment is received, and must remit these taxes in his or her next payment to the Department.

Any claim for a bad debt deduction must be supported by evidence required by the Department. The Department must review any change in the rate of taxation applicable to any taxable sales, rentals, or services by a seller claiming a deduction, and ensure that the deduction on any bad debt does not result in the seller's recovering any more or less than the taxes imposed on the sale, rental, or service that constitutes the bad debt.

Under the bill, "bad debt" means any portion of a debt resulting from a seller's collection of the use tax on the purchase of tangible personal property or services that is not otherwise deductible or excludable, that has become worthless or uncollectible, and that is eligible to be claimed, or could be eligible to be claimed if the seller kept accounts on an accrual basis, as a deduction pursuant to the IRC. A bad debt does not include any of the following:

-- Interest or use tax on the purchase price.
-- Uncollectible amounts on property that remains in the seller's possession until the full purchase price is paid.
-- Expenses incurred in attempting to collect any account receivable or any portion of the debt recovered.
-- Any accounts receivable that have been sold to a third party for collection.
-- Repossessed property.

Rolling Stock Exemption

Senate Bill 544 exempts from the sales tax, for taxes levied after April 30, 1999, sales of "rolling stock" purchased by an interstate motor carrier or for rental or lease to an interstate motor carrier and used in interstate commerce. Under the bill, "rolling stock" means a qualified truck (a commercial motor vehicle power unit, with dimensions as specified in the Act), a trailer designed to be drawn behind a qualified truck, and parts affixed to either the truck or the trailer.

The General Sales Tax Act defines "interstate motor carrier" as a person in the business of transporting persons or property, other than themselves, their employees, or their own property, for hire across state lines; total fleet mileage must include at least 10% driven outside the State in the preceding tax year.

House Bill 4586

The bill amended the Use Tax Act to provide that after April 30, 1999, the tax does not apply to the storage, use, or consumption of rolling stock used in interstate commerce and purchased, rented, or leased by an interstate motor carrier. Previously, the Act contained the exemption; however, it expired May 1, 1999.

MCL 205.51 et al. (S.B. 544)
205.94k (H.B. 4586)
205.93 et al. (H.B. 4744)
208.3 et al. (H.B. 4745)

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

Since its beginning, the SBT has been a detriment to business in the State and a disincentive for employers to locate here. The tax has been the source of continual complaints from business about its unfair nature. The fact that the tax is applied to business activity, rather than profits, has been particularly vexing to business because it has often required a business to pay significant taxes in a tax year even though the business made no profit that year. Further, taxing business activity means that the costs for wages, health care, other benefits, and other business expenses must be included in a firm's tax base, subject to tax after certain adjustments. This is a clear disincentive for a business to hire new employees. Not only must the business absorb the costs inherent in paying an employee's wages and benefits, it must at the end of the year pay taxes on those amounts it paid, thus inflicting upon itself a penalty for providing a job. It is no wonder that many have contended through the years that the SBT is a tax on job creation.

In addition, even the strongest proponents of the tax agree that calculating the tax liability of a business is enormously complicated, especially for a small firms that can't afford a full-time tax accountant. This often has resulted in an absurd situation in which a firm finds that its tax liability is less than the cost of paying someone to determine the liability. Thus, the tax has never been accepted by the taxpayers. By phasing the tax out of existence, House Bill 4745 will rid the business community of this continual frustration and burden.

Supporting Argument

The SBT places a heavy burden on business, in terms of both the level of the tax and the administrative tasks that it requires. When the costs of doing business are higher than they should be, both the business community and consumers suffer the effects. The gradual elimination of the tax over two decades, while not perfect, is an excellent solution to the problems found with the SBT. The State will not be made to deal with enormous revenue reductions each year, but will have time to adapt spending and taxing policies to adjust to the annual reductions. On the other hand businesses, while not completely relieved of the burdens of the SBT, will see yearly improvements in their tax status with the full knowledge that future years will bring further improvements. By cutting the costs of doing business, House Bill 4745 will create a competitive tax environment in the State, make Michigan more competitive in relation to other states. The bill creates major incentives for firms around the world to consider investing in a State where, at a set time in the future, there will be no specific tax on business. This will lock in a process that will keep Michigan's economy growing, and help to ensure the attraction of new high-paying jobs.

Response: Elimination of the SBT over 23 years does little or nothing for small businesses that need relief today. The tax is burdensome, and should be eliminated much sooner than outlined in House Bill 4745. Under the bill's schedule, businesses won't be competitive with other states for several years.

Supporting Argument

Eliminating the SBT, even over 23 years, will be great news for Michigan's job providers, and, in turn, Michigan consumers. High business tax burdens, in the end, only punish the consumer, because businesses pass on the cost of doing business (including taxes) to customers and clients. In effect, businesses don't pay taxes, they just collect them for the State.

Response: The contention that businesses don't pay taxes is misguided. A business must charge more than its costs to produce a product, in order to ensure a profit; however, it is also true that often businesses will charge whatever consumers will pay, thus generating profits far in excess of costs of production. In these cases, taxes may simply reduce the profit margin somewhat rather than being passed on to the consumer. That said, the claim that all taxes are passed on to the consumer is actually an argument in favor of the SBT. The State's largest manufacturers, especially auto producers, have always paid the bulk of the tax. Most of the products built by those manufacturers are sold outside the State. This means that, if taxes are paid by consumers, then the bulk of the SBT is being paid by consumers outside the State, and the tax burden has been exported.

Supporting Argument

Through a variety of methods, Michigan trucking firms have for many years received a partial exemption from sales and use taxes for purchases or leases of equipment, used in interstate commerce, from in-State businesses. Further, since 1993, equipment purchased or leased outside the State by Michigan firms engaged in interstate trucking has been exempt from the use tax. Because trucking equipment is very expensive, the exemptions have provided vital tax relief for purchasers. The expiration of the exemptions could have had serious consequences for Michigan interstate trucking firms. Even before the partial exemptions expired, Michigan trucking companies were at a competitive disadvantage because, reportedly, the majority of states including those adjacent to Michigan do not tax sales of trucks and trucking equipment. This meant, then, that while both in-State and out-of-State trucking firms competed for the same freight, Michigan companies had to pay more for their equipment purchases, if they got their equipment in the State. If they purchased or leased their equipment from a firm in another state, they avoided the use tax; however, this put Michigan equipment distributors at a competitive disadvantage to those in other states. By providing a full exemption for rolling

stock, Senate Bill 544 and House Bill 4586 removed a disincentive for Michigan interstate trucking companies to purchase new equipment, and standardized the exemption under each Act, so that there will be no disadvantage to purchasing or leasing equipment from a Michigan firm.

Supporting Argument

Both the General Sales Tax Act and the Use Tax Act contain exemptions for the sale or use of certain property or services. For many years, the Department of Treasury has required businesses that claim these exemptions to apportion the exemptions between exempt and nonexempt uses; that is, a business must determine the extent to which a product or service was used for an exempt purpose versus a nonexempt purpose and claim the exemption accordingly. The *Michigan Bell* opinion concluded that the Use Tax Act contained no provisions requiring a taxpayer to apportion taxes between exempt and nonexempt uses, meaning that if a product or service was used for an exempt purpose, regardless of its additional use for nonexempt purposes, the product or service was tax exempt. This could have had a substantial, negative impact on both sales and use tax revenue. Senate Bill 544 and House Bill 4744 eliminate this problem by specifying that exemptions must be apportioned, and thus codify the Department's long-time practice.

Supporting Argument

By creating a bad debt deduction under the Use Tax Act, House Bill 4744 addresses an issue that recently was before the Michigan Supreme Court (*World Book, Inc.* v *Department of Treasury*, 459 Mich 403 (1999)). In that case, the Supreme Court was asked to determine whether the absence of a bad debt deduction in the Act violated the Commerce Clause of the U.S. Constitution. The Court did not decide this question, however, because it found that the seller was not required to pay its customers' use taxes where the seller used reasonable business care in trying to collect them. According to the Court, "...before the seller is subjected to either tax liability... or criminal penalties..., the Use Tax Act requires intent or fault by the seller in its inability to collect the tax from its customers."

The bad debt deduction created by the House bill fills the gap in the Use Tax Act, and makes the Act consistent with the General Sales Tax Act, which allows bad debts to be deducted from the gross proceeds used to calculate sales tax liability.

Opposing Argument

The State already has cut taxes, including business taxes, several times in recent years. The bills will have a major impact on SBT revenues. These cuts, combined with earlier cuts to the income tax, will result in significant reductions in State revenue. This, in turn, might jeopardize the stability of school funding, since, for the most part, schools can no longer raise money on their own from property taxes but must rely heavily on State funding. This, then, may put tremendous pressure on all the other State budgets.

The SBT recently was changed in several ways to favor business; for instance, the gross receipts filing threshold was raised and the alternative tax rate was reduced; Social Security, unemployment compensation, and workers' compensation were removed from the tax base; and the apportionment formula was changed to increase the sales factor and decrease the payroll and property factors. The full impact of these changes should be measured first, before the drastic step of eliminating the tax is taken. If the State experiences an economic downturn in the future and finds itself short of revenue, the changes made by the bills will exacerbate the revenue problem. If such a situation develops, and the State needs to raise funds, some will argue that it would be unacceptable to reverse the gains that businesses have made. This will leave the State with few options, other than to raise taxes on individuals.

Response: The revenue implications will not be as severe as expressed. Simply saying that House Bill 4745 will reduce revenue fails to account for increased economic activity and thus greater application of existing taxes to a more vigorous economy fueled by more and better jobs.

Opposing Argument

The SBT replaced seven other taxes on business in 1976, providing stability to the State's tax revenue and simplifying the tax burden for firms. At that time it was deemed that the State's up-and-down economy caused fluctuations in State revenue that were difficult to deal with, and the SBT solved that problem in regard to business taxation. Despite the complications the SBT presents in calculating tax liability, the value added nature of the tax is the fairest way to tax business. Businesses use public infrastructure and State services, and they should pay something for that consumption. Measuring a business's activity in the State, and taxing that activity, is a fair way to measure how much a business should pay in taxes. Just like citizens, businesses have a social responsibility to support society's structures and institutions. Under House Bill 4745, while business will continue to demand their share of services and support from State and local governments, they will pay less and less each year. This simply is not sound tax policy.

Opposing Argument

By eventually eliminating the State's primary business tax, House Bill 4745 will place a greater onus on families and individual taxpayers to carry the tax burden; in fact, the bill will slowly but inexorably shift the overall responsibility for tax revenue to individuals. It has been pointed out that the State has cut taxes in many ways in recent years, and that

most of the cuts have been directed at individual taxpayers. While this might be true, individuals pay a far greater share than businesses do in terms of total State taxes. Therefore, it is logical that the cuts thus far should have favored individuals.

Legislative Analyst: G. Towne

FISCAL IMPACT

This package of bills will generate a net increase in revenue of $144 million in FY 1998-99, but will result in a net tax reduction in subsequent fiscal years including an estimated $184 million tax decrease in FY 1999-2000. The fiscal impact of these bills fall into two distinct groups; 1) tax reductions, and 2) a tax change to fix a sales and use tax problem identified in the Michigan Bell court case.

Tax Cuts. The tax cuts include the phased reduction of the single business tax rate, expansion of the sales and use tax industrial processing exemption, and the extension and expansion of the sales and use tax exemption for rolling stock. The size of the tax cuts will grow over time primarily due to the lowering of the single business tax rate by 0.1 percentage point each year from 1999 to 2021. The tax cuts will total an estimated $91 million in FY 1998-99 and $244 million in FY 1999-2000.

Michigan Bell Fix. In the *Michigan Bell* v *Department of Treasury* court ruling, it became apparent the Department had no authority to apportion the industrial processing exemption, which it had been doing for many years. As a result, businesses eligible for the industrial processing exemption had not been receiving the entire exemption to which they were entitled, and had therefore been overpaying the sales and use taxes. In order to provide an accurate assessment of State government revenues, the consensus revenue estimates adopted at the May 1999 Consensus Revenue Estimating Conference included the loss in revenue that would result from refunding past sales and use tax overpayments to these taxpayers, as well as the reduction in sales and use tax collections that would occur in future years. These bills, however, fix the court-identified problem by specifically allowing the industrial processing exemption to be apportioned between exempt and nonexempt purposes, based on how the equipment is used, which is exactly what the Department of Treasury had been doing for many years. Therefore, the revenue losses that would have resulted due to the court ruling and were reflected in the consensus revenue estimates, which total an estimated $235 million in FY 1998-99 and $60 million in FY 1999-2000, are completely offset by the provisions in these bills and therefore must be added back into the revenue estimates.

Estimated Fiscal Impact. The following table provides a summary of the estimated fiscal impact of this package of bills. The estimated fiscal impact is broken down for each of the major tax cuts, as well as the Michigan Bell fix. In addition, since the tax changes included in these bills will primarily affect the revenue going to the General Fund/General Purpose (GF/GP) budget and the School Aid Fund (SAF), estimates are also provided on how each of the major tax changes will affect the revenue going to each of these key budget areas.

Estimated Fiscal Impact of Business Tax Package: FY 1998-99 and FY 1999-2000 (dollars in millions)							
		FY 1998-99			FY 1999-2000		
Tax/Major Proposed Changes:	Bills	GF/GP	SAF	Total	GF/GP	SAF	Total
Tax Cuts:							
Single Business Tax]	H.B. 4745						
Reduce tax rate 0.1 percentage point/year.		$(86.8)	$0.0	$(86.8)	$(210.9)	$0.0	$(210.9)
Replace CAD with ITC.		0.0	0.0	0.0	0.0	0.0	0.0
Tax on Foreign Businesses		0.0	0.0	0.0	0.0	0.0	0.0
Corporate Restructuring, Tax Holdharmless		0.0	0.0	0.0	0.0	0.0	0.0
Subtotal Single Business Tax Cut		$(86.8)	$0.0	$(86.8)	$(210.9)	$0.0	$(210.9)
Sales & Use Taxes							
Expand Industrial Processing Exemption	H.B. 4744, S.B. 544	0.0	0.0	0.0	(13.5)	(9.5)	(23.0)
Expand & Extend Rolling Stock Exemption	H.B. 4586, S.B. 544	(1.0)	(3.1)	(4.1)	(2.5)	(7.9)	(10.4)
Subtotal Sales & Use Tax Cut		(1.0)	(3.1)	(4.1)	(16.0)	(17.4)	(33.4)
Total Tax Cuts		$(87.8)	$(3.1)	$(90.9)	$(226.9)	$(17.4)	$(244.3)
Michigan Bell Fix*							
Apportioning Industrial Processing Exemption -	H.B. 4744, S.B. 544	137.9	97.2	235.1	35.2	24.8	60.0
Net Fiscal Impact Total Package		**$50.1**	**$94.1**	**$144.2**	**$(191.7)**	**$7.4**	**$(184.3)**

* Consensus revenue estimates for FY 99 and FY 2000 included estimates of the tax loss that would result from the Michigan Bell court case. These legislative changes fix the court-identified problem and therefore, the revenue losses currently in the consensus revenue estimates are entirely offset by the provisions in these bills.

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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.