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DEFINITION OF 'BUSINESS INCOME'

House Bill 4557 as enrolled
Public Act 52 of 2003
Second Analysis (8-8-03)

Sponsor: Rep. Barbara Farrah
House Committee: Tax Policy
Senate Committee: Finance

THE APPARENT PROBLEM:

The Granholm Administration has proposed a series of changes in the state's tax laws that are linked to the governor's proposed state budget for fiscal year 2003-2004. These changes have been characterized, not without controversy, as "closing loopholes" in the current tax system. One of the proposals would amend the definition of the term "business income" for purposes of administering the state's income tax. Treasury officials have said the purpose of the proposed amendment is to prevent nonresident taxpayers from characterizing "business" income as "nonbusiness" income in order to reduce or eliminate the tax to be paid to Michigan.

[Under the Income Tax Act, "business income" is defined to mean income arising from transactions, activities, and sources in <u>the regular course of business</u> of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, rental, management, and disposition of the property are considered to be integral to the taxpayer's regular trade or business operation. (Emphasis added)]

The Department of Treasury has described the problem as follows.

Some nonresident taxpayers have argued the definition of "business income" in the Income Tax Act limits the type of income Michigan can tax. A nonresident taxpayer who receives income from business activity conducted here must pay income tax to this state on all or a portion of that income. However, if that nonresident taxpayer characterizes the income as "nonbusiness" income, Michigan will not receive any tax revenue from that Michigan activity. This is because while business income is taxed on a pro rata basis by all of the states in which a taxpayer's business activity occurs, nonbusiness income is generally allocated 100 percent to the taxpayer's state of residence.

The department offered as an example the case of a nonresident with business activity in Michigan who sells a part of its Michigan business to another company. The nonresident could then argue that the income from the sale is not business income because the sale is an isolated transaction rather than a part of its regular course of business. If this argument was accepted, says the treasury department, Michigan would receive no tax revenue from the sale of the business. To address this problem, legislation has been introduced to clarify the definition of "business income".

THE CONTENT OF THE BILL:

Under the Income Tax Act, "business income" is defined to mean income arising from transactions, activities, and sources in the regular course of business of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, rental, management, and disposition of the property are considered to be integral to the taxpayer's regular trade or business operation.

The bill would amend the act to specify that "business income" also includes, but is not limited to, the following:

- Gains or losses from stock and securities of any foreign or domestic corporation and dividend and interest income;

- Income derived from isolated sales, leases, assignment licenses, divisions, or other infrequently occurring disposition, transfers or transactions involving property if that property is or was used in the taxpayer's trade or business operation; and

- Income derived from the sale of a business.

No later than two years after the bill takes effect, the Department of Treasury would have to report to the House Tax Policy Committee and the Senate Finance Committee on the impact on the tax liability of resident and nonresident taxpayers of including gains and losses from stock and securities and dividend and interest income within the definition of "business income".

MCL 206.4

FISCAL IMPLICATIONS:

The House Fiscal Agency cites estimates from the Department of Treasury that the bill would increase income tax revenue by about $6 million. Of that, about $1.5 million would be earmarked to the School Aid Fund and the rest to the General Fund. (HFA fiscal analysis dated 5-1-03)

ARGUMENTS:

For:

The bill would clarify the definition of "business income" in the Income Tax Act in order to ensure that Michigan does not lose tax revenue it properly ought to be able to collect. It makes it clear that income from isolated transactions, such as the sale of a business, and income from investments are to be treated as "business" income and are to be subject to Michigan income taxes. Note that the bill does not apply to corporations, but to business entities in which income (and tax liability) flows to individuals, such as partnerships, S-corporations, and limited liability companies.

Response:

Business interests have questioned whether this bill makes good tax policy. They say some multi-state individual filers face apportionment in many or all states in which they do business and this would seem to complicate the administration of capturing business taxes from such individuals.

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