Legislative Analysis

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MICHIGAN JOBS AND INVESTMENT ACT

House Bill 4476
Sponsor: Rep. Paul Condino
Committee: Tax Policy

Complete to 6-21-05

A SUMMARY OF HOUSE BILL 4476 AS INTRODUCED 3-9-05

House Bill 4476 implements Governor Granholm's proposed amendments to the Single Business Tax Act by establishing a new Chapter 5A. The key elements of the proposal are listed first. Later there is a section-by-section description of the bill. The Fiscal Impact section also contains information about the General Property Tax Act amendments in a related bill, House Bill 4477.

The bill would do the following.

• Establish the standard SBT tax rate at 1.2 percent for tax years beginning on or after January 1, 2006. This is a reduction from the current rate of 1.9 percent.

• Change the apportionment formula used by multi-state businesses to determine the amount of business activity attributable to Michigan so that it would be based entirely on sales. Currently, the formula is weighted 90 percent sales, 5 percent payroll, and 5 percent property.

• Create a refundable personal property tax credit against the SBT for industrial processors and research and development companies equal, generally speaking, to 35 percent of the taxes paid for personal property used in industrial processing, including research and experimental activities.

• Provide a refundable credit against the SBT to research and development companies equal to 1.2 percent of the compensation provided in connection with research and experimental activities.

• Reduce the rate of the small business alternative tax, which is one way of calculating the small business credit, from 2 percent to 1.2 percent.

• Add to the tax base of corporations (other than S-corporations) two times the sum of 1) business income reduced by dividends, and 2) the add back of the net operating loss carryforward. This would essentially "triple weight" profits in calculating tax liability, making the SBT more like a corporate income tax for affected taxpayers.

• Specify that in determining the tax base of professional employer organizations (PEOs), compensation paid by the PEO to the officers of a client company would be included in the compensation of the client company (and not the PEO).

• Impose a tax on insurance companies equal to two percent of gross direct premiums written on property or risks located or residing in the state. This would replace the current method of taxing insurance companies.

• Repeal the excess compensation reduction, the gross receipt reduction, and the unincorporated business/S-corporation credit.

• Extend the life of the SBT indefinitely. The act is scheduled to be repealed for tax years after December 31, 2009.

The following is a section-by-section analysis of the bill. Included in *italics* in some sections is a description, provided by the Department of Treasury, of what each section aims to accomplish. The department's language is included as an aid to understanding rather than as advocacy for the amendments.

Section 102: Legislative Findings

The bill includes a statement that the legislature finds that reducing the tax rate and broadening the tax base improve the measurement of value added from all forms of business activity and maintain the SBT as a modified value added tax.

This section helps protect against a lawsuit challenging the status of the SBT as a value added tax. Such a lawsuit could reduce the number of out of state businesses that are subject to the tax.

Section 103: Definitions

The bill defines "adjusted gross income", "business income", "client", "corporation", "professional employer organization", and "temporary employee."

Of note, the bill defines "business income" to generally mean federal taxable income plus the amount of a deduction claimed under Section 199 of the federal Internal Revenue Code related to domestic production activities. For a person other than a corporation, business income means that part of federal taxable income derived from business activity plus the amount of the deduction claimed under Section 199 of the IRC. For a partnership, business income includes payments and items of income and expense that are attributable to business activity of the partnership and are separately reported to the partners of the partnership.

The definition of "business income" is quite similar to the current definition contained in the Section 3(3) of the SBT Act, though the current definition does not include the reference to the deduction claimed under Section 199 of the federal IRC for domestic production activities. Section 3(3) would be repealed by the bill.

The bill includes a definition for "professional employer organization" that is similar to the current definition in Section 4(4), which would be repealed by the bill.
The definition of 'business income" excludes the new federal deduction for production activities, effective this year.

Section 104: SBT Rate

The bill would establish the standard SBT tax rate at 1.2 percent for tax years that begin on or after January 1, 2006, reducing it from the current rate of 1.9 percent.

The SBT rate, now contained in Section 31 (MCL 208.31), was initially set at 2.35 percent, and was lowered to 2.3 percent in 1994 through the enactment of Public Act 247. In 1999, Public Act 115 began to phase-out of the tax by lowering the rate by 0.1 percentage point annually, if the balance of the budget stabilization fund was greater than $250 million. The rate dropped by 0.1 percent annually on January 1 from 1999 to 2002, and is currently set at 1.9 percent.

Section 105: Apportionment Factor

To determine their tax liability, businesses that have business activity in Michigan and other states must calculate how much of their total business activity is apportioned to Michigan. The apportionment formula is based on three factors: payroll, property, and sales. A weighted average of those three factors is used to determine the business activity attributable to Michigan, with sales weighted at 90 percent, and payroll and property weighted at 5 percent each. As an example, a business with 20 percent of its sales, 70 percent of its payroll, and 70 percent of its property in Michigan would apportion 25 percent – [(.90*.20)+(.05*.70)+(.05*.70)] – of its total tax base to Michigan.

House Bill 4476 would eliminate the payroll and property factors and base apportionment entirely on sales. The change would not affect Michigan-only businesses; it would only apply to multi-state businesses. In general, it would reduce liabilities of businesses with payroll and property in Michigan with a high level of out-of-state sales, and increase liabilities of out-of-state businesses that have a relatively high level of sales in Michigan.

Originally, each apportionment factor was weighted equally (33 1/3 percent). The trend, in Michigan and elsewhere in recent years has been to weight the sales factor more heavily than the other two. Public Act 77 of 1991 altered the formula to weight the sales factor more heavily (40 percent) than payroll and property (30 percent each) for 1991 and 1992. For 1993 and subsequent years, Public Act 77 weighted the sales factor at 50 percent, and payroll and property at 25 percent each. Public Act 283 of 1995 weighted the sales factor at 80 percent, and payroll and property at 10 percent each. Public Act 282 of 1995 established the current apportionment formula weighing sales at 90 percent, and payroll and property at 5 percent each.

Section 106: Personal Property Tax Credit

The bill would create a refundable credit against the SBT for industrial processors and research and development companies generally equal to 35 percent of the taxes paid for personal property used for industrial processing, including research or experimental activities. Taxes paid on personal property that is primarily used to support retail sales or other commercial activities would not be used to calculate the credit.

For industrial processors whose only significant business activity is industrial processing and related support activities, the credit would be calculated using 90 percent of the personal property taxes paid and reported by the industrial processor. Other industrial processors and research and development companies would be required to separately file a personal property statement with the local assessor for property used for industrial processing, or research or experimental activities, and calculate the credit using the property taxes paid for that property. An affiliated group, a controlled group or corporations, or an entity under common control would not claim the credit as a research and development company unless the entities' business activities are consolidated

Under the General Property Tax Act, businesses in the state pay property taxes on both real property and personal property. For the purposes of administering the tax, personal property is self-reported to local assessors by each business on a personal property statement that includes a list of each item and its age. Local assessors then assign a taxable value to each item using depreciation schedules. Generally speaking, personal property is taxed in the same manner as other real property in a local governmental unit.

Section 107: Research and Development Compensation Tax Credit

The bill would provide a nonrefundable credit against the SBT to research and development companies equal to 1.2 percent of the compensation attributable to research and experimental activities. [Given that the SBT rate under the bill would be 1.2 percent, this credit effectively eliminates the tax on the compensation paid to research and development employees.] The credit would be claimed against a taxpayer's SBT liability after the application of the personal property tax credit provided in Section 106.

Section 108: Small Business Credit/Alternative Tax Rate

Under current law (MCL 208.36) certain small, low-profit businesses may calculate their SBT tax liability by using one of two methods. The current provision would largely be reenacted into Section 108 of the bill with three notable changes: (1) the bill would reduce the rate of the small business alternative tax, one method of calculating the credit, from 2 percent to 1.2 percent; (2) the bill would provide that limited liability companies are subject to the same compensation limits as other businesses; and (3) the bill would provide that affiliates of out-of-state companies are subject to the same combined gross receipts limits as affiliates of in-state companies.

Under the act, small business may either claim the small business credit or calculate their tax liability using the alternative tax rate. The small business credit was first established with Public Act 273 of 1977, and is available to firms meeting the following criteria: (1) gross receipts not exceeding $10 million, (2) adjusted business income not exceeding $475,000, and (3) individual shareholder or officer-allocated income not exceeding $115,000. The credit is based on the ratio of adjusted business income to 45 percent of the SBT base. After application of the credit, a firm's tax liability is equal to the product of (1) the tax liability before the credit, and (2) the quotient of adjusted business income and 45 percent of the tax base.

Public Act 390 of 1988 established the alternative tax for small business. A firm's tax liability under this method is equal to two percent of adjusted business income. The alternative tax rate was initially set at four percent, and decreased to three percent for the 1992 and 1993 tax years, and lowered to the current rate for tax years beginning October 1, 1994. It should be noted that while the current alternative tax rate is slightly higher than the current standard rate of 1.9 percent, the alternative tax is levied on a much narrower tax base. Nevertheless, the bill would establish both rates at 1.2 percent.

This section cuts the rate for small businesses using the alternative calculation. In addition, this section makes eligibility standards for the small business credit apply uniformly to all types of business organizations and eliminates favorable treatment for small business with an out-of-state affiliate.

Section 109: Increase Profit Component of the Tax Base

For tax years beginning on or after January 1, 2006, the bill would add to the tax base of certain businesses two times the sum of the following (if positive): (1) business income reduced by the amount of dividends, and (2) the add back of the net operating loss carry forward. This change would effectively "triple-weight" profits, and makes the SBT more like a corporate income tax for those affected taxpayers.

The addition would only apply to corporations other than S-corporations. It would not apply to partnerships, limited liability companies filing as partnerships, or sole proprietorships.

This section makes the SBT more profit sensitive by providing additional weighting of profits for businesses filing as corporations.

Section 110: Professional Employer Organizations

House Bill 4476 provides that, for tax years that begin on or after January 1, 2006, compensation paid by a PEO to the officers of a client company would be included in the compensation of the client company (and not the PEO).

The bill provides that for PEO's with at least a one percent common ownership with a client, or for PEO's with at least a one percent ownership interest in a client, or for PEO's where the client has at least a one percent ownership interest in the PEO, a client's compensation includes compensation paid by the PEO to officers of the client or employees assigned to the client. Where there is some sort of common ownership between the client and the PEO, the PEO and client company could instead jointly elect to include the leased employees' compensation in the tax base of the PEO, not the client. If they elect to do so, the PEO and client would not be able to claim the small business credit under Section 108 (formerly Section 36) of the act.

A professional employer organization (PEO) is a company that contractually assumes and manages critical human resources and personnel responsibilities typically for small and mid-sized businesses. A business will contract with a PEO to provide it with staff or employees, and both function as co-employers. Each has control over these employees in terms of hiring and firing; the client company directs the day-to-day work of the employee (just like any other employer-employee relationship), but the PEO is responsible for the human resource management, such as payroll, worker's compensation, and health benefits.

Public Act 603 of 2002 amended the SBT Act to specify that compensation paid by a PEO to an "employee" of the client company is considered to be compensation included in the tax base of the PEO, not the client. The client company is still responsible for any tax liability, including the SBT, but the compensation paid to its "employees" by a PEO is not used to determine its SBT base.

Eliminates the use of professional employer organizations to avoid eligibility rules and, as a result, obtain the small business credit.

Section 111: Insurance Premiums Tax

Under current law, insurance companies are liable for the Single Business Tax <u>or</u> the so-called retaliatory tax (if applicable) levied under the Insurance Code, whichever is greater. The Single Business Tax Act (208.22a) provides that the tax base and adjusted tax based of an insurance company is 25 percent of the company's adjusted receipts, subject to any apportionment. In addition, insurance companies are subject to a "surcharge" under MCL 208.22b equal to 1.26 times the company's tax liability. The total tax of an insurance company under the SBT calculates out to be 1.0735 percent of the company's adjusted receipts.

The bill would, instead, impose a tax for tax years beginning after December 31, 2006 equal to two percent of gross direct premiums written on property or risk located or residing in the state. Direct premiums would not include premiums on policies not taken, return premiums on canceled policies, receipts from the sale of annuities, or receipts on reinsurance premiums of the tax has been pad on the original premiums.

The section also incorporates many provisions currently contained in Section 22f.

Section 112: Severability

The bill provides that if a final order of a court of competent jurisdiction determines that any provision of the act that provides a deduction, credit, or exemption with respect to employment, persons, services, taxes, investment, or any other activity that limited only to this state is unconstitutional or applies outside of the state, that deduction, credit, or exemption would be severed from the act in its entirety and would not be effective in the tax year for which the ruling applies. The remaining provisions would remain in effect.

This section protects the tax from lawsuits attacking credits and deductions, based on the federal Courts of Appeals' (Sixth Circuit) decision in Cuno v. Daimler-Chrysler.

Section 113: Federal Income Tax Nexus Standards/Repeal of Section 109

The bill provides that if a final order of a court of competent jurisdiction determines that any provision of the act is subject to the limitations of 15 U.S.C. 381(a), then Section 109 of the bill is severed from the act and, as a replacement, a separate levy would be imposed on corporations, other than S-Corporations, equal to 2.4 percent of the sum of the following: (1) business income reduced by the amount of dividends, and (2) the add back of the net operating loss carry forward.

This section protects against severe revenue loss if the courts decides that the new tax structure is subject to more restrictive federal nexus standards currently applicable to an income tax.

Section 114: Repealed provisions

The bill would repeal several provisions for tax years that begin on or after January 1, 2006. Of note, the bill repeals the excess compensation reduction, the gross receipts reduction, and the unincorporated business/S-Corporation credit.

-- Section 4(4): This provision, added by Public Act 603 of 2002 specifies that compensation paid by a professional employer organization to an "employee" of the client company is considered to be compensation included in the tax base of the PEO, not the client. Provisions in the bill pertaining to professional employer organizations are included in Section 110.

-- Section 3(3): This provision defines "business income." A new, slightly different, definition would be included in Section 103 of the bill.

-- Sections 22a to 22f: These sections pertain to the taxation of insurance companies. Section 111 of the bill provides for a new means of taxing insurance companies. Much of section 22f is now incorporated into Section 111 of the bill.

-- Section 31(2): This provision provides for the gross receipts reduction. Under the act, if a business's adjusted tax base exceeds 50 percent of its adjusted gross receipts (that is, gross receipts apportioned to Michigan and any capital acquisition deduction recapture) the business may calculate its tax liability using the gross receipts reduction method. This method permits a business to reduce its tax base by the amount that the adjusted tax base exceeds 50 percent of adjusted gross receipts. This, in essence, reduced the tax base to an amount equivalent to 50 percent of its adjusted gross receipts. Businesses may also calculate their tax liability using the gross receipts "short method" (a simplified version of the gross receipts reduction method) that calculates the adjusted tax base as being 50 percent of adjusted gross receipts. In an August 2003 report, the Department of Treasury reported that approximately 18,000 businesses (12 percent of all filers) utilized either the gross receipts reduction method or the gross receipts short method, reducing SBT liability by an aggregate amount of $240.5 million in FY 1999-2000. Over one-fifth of all firms in the service sector and the finance, insurance, and real estate (FIRE) sector use these calculation methods.

-- Section 31(4): This provision provides for the excess compensation reduction. This method allows a business, in calculating its tax liability, to reduce its tax base by the amount total compensation exceeds 63 percent of its tax base. Under this method, the adjusted tax base is reduced by an amount equal to the percent by which compensation exceeds 63 percent of the tax base, up to a maximum of 37 percent. For example, if compensation represents 80 percent of a business's total tax base, the business may reduce its adjusted tax base by 17 percent (80 percent - 63 percent = 17 percent). Businesses that use the excess compensation reduction method and that also claim the Investment Tax Credit (ITC) must also reduce their ITC by an amount proportionate to their compensation reduction. (In the above example, a business would have to reduce its ITC by 17 percent.)

-- Section 31(5): This provision provides that if the balance of the budget stabilization fund exceeds $250 million at the close of a fiscal year, the rate of the SBT tax shall be reduced by .1 percentage point on the January 1 following the close of that fiscal year.

-- Section 36: This provision provides for the small business credit. A similar provision is included in Section 108 of the bill.

-- Section 37: This section provides for the unincorporated businesses and S-corporations credit, in an amount based on their business income. If business income is $20,000 or less, the credit is equal to 20 percent of the business's tax liability (before the credit). If business income is between $20,000 and $40,000, the credit is equal to 15 percent of its liability. If business income is $40,000 or more, the credit is equal to 10 percent of its liability. According to a 2003 report by the Department of Treasury, approximately 54,000 businesses claimed the credit in FY 1999-2000, totaling $72.7 million.

-- Section 39: This section provides a credit to public utilities equal to five percent of their property taxes imposed under Public Act 282 of 1905. The Department of Treasury reports that 48 firms claimed $3.6 million in credits in FY 1999-2000.

-- Section 45: This section provides for the apportionment of business activity to the state for tax years beginning before January 1, 1999.

-- Section 45a: This section provides for the apportionment of business activity to the state for tax years beginning after December 31, 1998. The apportionment provisions are contained in Section 105 of the bill.

This section creates a broader tax base, in conjunction with a lower rate, and removes the rate reduction trigger.

Section 115: Tax Years

The bill provides that for the purposes of the SBT Act, a taxpayer that has a 52-week tax year beginning within seven before December 31 of any year is considered to have a tax year that begins after December 31 of that year.

This section prevents the delay of tax cuts for certain unusually situated taxpayers.

Enacting Sections:

-- The bill would repeal Enacting Section 1 of Public Act 531 of 2002, which repeals the Single Business Tax Act for tax years that begin after December 31, 2009.

This section would continue a state business tax beyond the current scheduled repeal.

-- The bill would repeal Enacting Section 3 of Public Act 115 of 1999, which repealed the Single Business Tax Act after the rate was reached zero percent.

-- The bill is tie-barred to Senate Bill 295 or House Bill 4477, meaning that House Bill 4476 would not take effect unless Senate Bill 295 or House Bill 4477 is also enacted into law.
This section preserves elements of the proposed tax changes as a single package. The WPW case is addressed in the tie-barred companion bill.

FISCAL IMPACT:

House Bill 4476 would amend the single business tax act to add language referred to as the "Michigan Jobs and Investment Act." The bill would provide for rate changes, new credits, the elimination of deductions and credits, and other changes to existing provisions. According to the Department of Treasury, the bill would reduce SBT revenue by an estimate $30.0 million. All SBT revenue is General fund/General Purpose revenue.

House Bill 4477, the other bill in the package, would amend the General Property Tax Act to prohibit reductions in occupancy for commercial property from lowering taxable values. According to the Department of Treasury, the bill would increase School Aid Fund (SAF) sources by an estimated $30.0 million ($7.5 million increase in State education tax revenue and a decrease in expenditures of $22.5 million). In addition, property tax revenue for local units of government would increase by an estimated $35 million.

Estimated Fiscal Impact of Michigan Jobs and Investment Act (MJIA) Components

Components	**Millions of $**
HB 4476 - Single Business Tax Act	
Rate Cut	-739
Manufacturing Personal Property Credit	-272
R&D Personal Property Tax Credit	-15
R&D Compensation Credit	-20
100% Sales Factor Apportionment	-40
Adjustments to Tax Base	801
Increase Weighting of Profits	
Eliminate Excess Compensation Reduction	
Eliminate Gross Receipts Reduction	
Eliminate Special Credit for Unincorporated Businesses	
Treat Compensation of Employees Leased From a PEO	
as Compensation of the Client Business	
Make Small Business Credit Eligibility Independent of	
Business Organization or Out of State Affiliation	
Rate Increase on Insurance	255
Total SBT Fiscal Impact	**-30**
HB 4477 - General Property Tax Act	
WPW Case	30
Total Property Tax Fiscal Impact	**30**
Total Fiscal Impact of MJIA	**0**

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