Legislative Analysis

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SBT AMENDMENTS

House Bill 5098
Sponsor: Rep. Paul Condino
Committee: Tax Policy

Complete to 8-24-05

A SUMMARY OF HOUSE BILL 5098 AS INTRODUCED 8-17-05

The bill would make a variety of amendments to the Single Business Tax Act to do the following:

- Add to "business income" the amount of the federal domestic production activities deduction.
- Include auto floor plan interest payments and credits made to dealers by manufacturers as part of the tax base.
- Subject insurance companies to the sales tax and use tax.
- Reduce the amount of the gross receipts reduction (increasing the SBT base).
- Reduce the amount of the excess compensation reduction (increasing the SBT base).
- Add to tax liability, the amount of the farmland preservation credit received under the Farmland and Open Space Preservation Act.
- Treat members of a limited liability company (LLC) like officers, shareholders, partners, and individuals for purposes of the small business credit.
- Include all members of a group of companies with common ownership in determining whether a controlled group is small enough to take the small business credit.
- Eliminate the apprenticeship credit as of September 30, 2005.
- Prevent firms with an unused SBT loss or credit obtained while filing separately from using up that loss or credit faster by filing a joint return with an affiliate in a later year.
- Specify that underpayment due to some of the changes proposed in the bill would not subject the taxpayer to penalties imposed under the act.

Business Income and the Federal Domestic Production Activities Deduction

The starting point in calculating a firm's single business tax liability is the firm's "business income", which the SBT Act defines to mean federal taxable income or, for a firm other than a corporation, that part of federal taxable income derived from a business activity.[1] The bill would add that "business income" also includes the amount of a deduction claimed under Section 199 of the Internal Revenue Code related to domestic production activities. This provision was also included in the governor's proposed Michigan Jobs and Investment Act (House Bill 4476).

The Domestic Production Activities Deduction, effective for tax years beginning after December 31, 2004, was recently added to the Internal Revenue Code with the enactment of the American Jobs Creation Act of 2004 (P.L. 108-357). Ostensibly the deduction was created to offset the repeal of the extraterritorial income exclusion (EIE) that was necessary to bring the U.S. into compliance with a World Trade Organization ruling that found the EIE to be an illegal export subsidy. When fully phased in, the deduction is equal to nine percent of the taxpayer's "qualified production activities income" or taxable income, whichever is less, and limited to half of wages paid in the calendar year.[2]

According to a June 2005 survey by the Foundation of Tax Administrators, the District of Columbia and 13 states have made a determination to not conform with the deduction, while five others were considered likely to not conform. Those 13 states identified by the FTA that do not conform to the deduction include: Arkansas, Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Mississippi, North Dakota, North Carolina, Tennessee, Texas, and West Virginia. The FTA's survey identified California, Minnesota, New Hampshire, New Jersey, and South Carolina as being likely to not conform to the deduction. Of those, legislation passed in Minnesota, New Jersey, and South Carolina since the survey results were released, and legislation is still pending in California.

Auto Floor Plan Interest

The SBT act generally requires that all interest paid by a taxpayer be included in the SBT base, to the extent that it is not already included in federal taxable income. (Similarly, the act provides that interest payments included in calculating federal taxable income should also be excluded when determining state business income.) The act itself does not define what constitutes interest, although it specifically excludes payments or credits made to or on behalf of a taxpayer by a manufacturer, distributor, or supplier of inventory to defray any part of the taxpayer's floor plan interest, if such payments are used by the taxpayer to reduce interest expense in determining federal taxable income.[3] The bill specifies that

[1] The act further defines "federal taxable income" to mean taxable income as defined in Section 63 of the federal Internal Revenue Code in effect on January 1, 1999 or, at the taxpayer's option, in effect for the tax year.

[2] The percentage of income gradually increases to a maximum of nine percent for the 2010 tax year and beyond. For tax years 2005 and 2006, the percentage is three percent, and for tax years 2007 through 2009, the percentage is six percent.

[3] Citing the state Supreme Court's opinion in *Town & County Dodge v. Department of Treasury*, 420 Mich 226, the Department of Treasury's Internal Policy Directive 2003-5 defines "interest" to mean "compensation allowed by law or fixed by the respective parties for the use or forbearance of money, a change for the loan or forbearance of

only such payments made before October 1, 2005 would not be considered as interest. (Payments made on and after that date would be included as interest and, as such, would be taxable.)

This provision in the act stems from a dispute between the Department of Treasury and automobile dealers that first arose in the late 1970's and early 1980's. Typically, auto dealers must borrow to finance the purchase of inventory (floor plan). Since the late 1970's automobile manufacturers have often reduced a dealer's borrowing costs through special interest reduction programs, including offering credits against purchases of inventory and direct payments to financial institutions on behalf of the dealer. In the mid-1980's treasury department auditors discovered that dealers were adding back in to their SBT base only their net interest costs, not the total interest costs that included the manufacturers' subsidies. Apparently there was some disagreement between manufacturers and dealers over who should be responsible for paying taxes on this interest expense, and neither group did, thereby resulting in a loss of revenue to the state. The legislature and governor enacted Public Act 80 of 1985 specifying that these subsidies were not considered interest for tax years from 1979 to 1984. Legislation has been enacted over the past two decades to continue to exclude these subsidies from being considered as interest and, therefore, taxable under the SBT Act.[4] The bill would effectively end this practice for payments made on and after October 1, 2005.

SBT Treatment of Insurance Companies

Under current law, insurance companies are liable for the SBT or the so-called retaliatory tax (if applicable) levied under the Insurance Code, whichever is greater. The SBT Act provides that that tax is imposed "in lieu of all other privilege or franchise fees or taxes imposed by any other law of this state, except taxes on real estate and personal property, and except as otherwise provided in this act and in [the Insurance Code]." The bill would add that insurers are also subject to the sales tax and use tax.

The act provides that the tax base and adjusted tax base 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.

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

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money, or a sum paid for the use of money, or for the delay in payment of money." The SBT Act defines "floor plan interest" as interest paid that finances any part of the taxpayer's purchase of automobile inventory from a manufacturer, distributor, or supplier. However, amounts attributable to any invoiced items used to provide more favorable floor plan assistance to a taxpayer than to a person who is not a taxpayer is considered interest paid by a manufacturer, distributor, or supplier.

[4] See Public Act 294 of 1989 (SB 397); Public Act 169 of 1991 (HB 5074); and Public Act 105 of 1993 (HB 4857)

deduction recapture) the business may calculate its tax liability using the gross receipts reduction method. The bill would increase the calculation threshold from 50 percent of gross receipts to 53 percent of gross receipts for the period beginning on and after October 1, 2005.

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, reduces the tax base to an amount equivalent to 50 percent of 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. Under the governor's proposed Michigan Jobs and Investment Act (HB 4476), the gross receipts reduction would be eliminated.

Excess Compensation

The excess compensation reduction allows a business, in calculating its tax liability, to reduce its tax base by the amount that total compensation exceeds 63 percent of its tax base. Under this method, the adjusted tax base is reduced by amount equal to the percent by which compensation exceeds 63 percent of the tax base, up to a maximum of 37 percent. The bill would increase to calculation threshold from 63 percent to 66 percent, thereby allowing a maximum reduction of 34 percent of the tax base.

Under current law, for example, if compensation represents 80 percent of a business's total tax base, the business may reduce its tax base by 17 percent (80 percent – 63 percent = 17 percent). Under the bill, that same business would reduce its tax base by 14 percent (80 percent – 66 percent = 14 percent). Additionally, 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, the business would have to reduce its ITC by 17 percent or, under the bill, 14 percent.)

The Department of Treasury reports that, in FY 1999-2000, nearly 47,000 firms (32 percent of all filers) used the excess compensation reduction, reducing their tax liability by $306.4 million. Half of all manufacturing firms filing an SBT return used this reduction. The excess compensation reduction would also be eliminated by the proposed Michigan Jobs and Investment Act (HB 4476).

Farmland Preservation Credit Addback

The bill would require a taxpayer that receives a farmland preservation credit under Part 361 of the Natural Resources and Environmental Protection Act to add to the taxpayer's tax liability an amount equal to amount of the credit claimed.[5]

Under Part 361, the owner of farmland and related buildings that are subject to a development rights agreement, agricultural conservation easements, or purchases of development rights may claim a credit under the SBT Act for the amount by which the property taxes on the land and buildings used in farming operations restricted by the development rights agreement, agricultural conservation easement, or purchases of development rights exceeds 3.5 percent of the adjusted business income of the owner, plus compensation to shareholders not included in adjusted business income, but excluding a deduction under Section 613 of the federal Internal Revenue Code.

Small Business Credit

Under the act, certain small, low-profit businesses may calculate their SBT liability by either claiming the small business credit or calculating their tax liability using the alternative tax rate. The bill would provide that limited liability companies are subject to the same compensation limits as other businesses and that affiliates of out-of-state companies are subject to the same combined gross receipts limits as affiliates of in-state companies when utilizing the credit or alternative tax rate.

The small business credit was first established with the enactment of 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, (3) and 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.

This provision would also be added under the proposed Michigan Jobs and Investment Act (HB 4476), and was also part of the tax loophole package of legislation from last session that accompanied Governor Granholm's FY 2004 Executive Budget Recommendation. The Department of Treasury contends that members of a limited

[5] Part 361 of NREPA is formerly Public Act 116 of 1974, and is still commonly known as PA 116.

liability company are not treated in the same manner as officers, shareholders, partners, and individuals for the purpose of the small business credit because the law has not been updated to include this relatively new business form. This enables LLC's that compensate members in excess of the limits to continue to receive the credit.

The department further notes that members of a group of companies with common ownership are required to combine their activities for the purposes of the small business credit, although, due to a 1987 state court of appeals decision[6] only those companies that are physically located or taxable in Michigan are included in determining eligibility for the credit. As such, a business can be disqualified from the credit if it is owned by a Michigan business, but be eligible for the credit if it is owned by a similar business without ties to Michigan.

According to the Department of Treasury, this provision 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.

Apprentice Credit

Under the act, a taxpayer may claim a refundable credit for each apprentice and "special apprentice" trained by the taxpayer in the tax year. The credit is equal to the sum of the following: (1) one-half of salary, wages, fringe benefits, and other payroll expenses paid to or for the benefit of the apprentice; and (2) the costs of classroom instruction and related expenses for which the taxpayer is responsible under an apprenticeship agreement. The credit is capped at $2,000 (or $4,000 for tool and die companies) for each apprentice and $1,000 for each special apprentice. The bill would only allow expenses incurred before October 1, 2005 to be used to calculate the credit.

The act defines "apprentice" to mean a state resident who is between 16 and 19 years of age and has not obtained a high school diploma, but is enrolled in a GED program, and is trained in an approved apprenticeship program. A "special apprentice" is defined to mean a state resident who between 16 and 24 years of age and is trained in an approved apprenticeship program.

Credit & Loss Carryforward

Under the act, a firm can "carryforward" certain credits and losses to offset tax liability into a specified number of years in the future if they exceed the firm's tax liability in the years in which they are first claimed. For example, the act permits a firm to claim a credit for expenditures to rehabilitate a historic resource, and further provides that the amount of the credit and any unused carryforward that exceeds the firm's tax liability for the tax year can be carried forward to offset tax liability for ten years or until used up, whichever occurs first.

[6] Alameda Gage Corp. v. Department of Treasury, 159 Mich. App. 693 (1987)

The bill would amend the act to specify that a business that filed a consolidated or combined return could not claim a credit carryforward or loss carryforward in an amount greater than the amount that could have been claimed if the member (i.e. a subsidiary) from whom the carryforward originated was filing a separate return, if the carryforward was from a year in which the member did not file a return on a consolidated or combined basis.

Additionally, a similar provision would apply, for tax years beginning on and after January 1, 2006, would apply to a taxpayer that files a return that includes a disregarded entity under the federal Internal Revenue Code. A business that files a return that includes a disregarded entity could not claim a credit carryforward in an amount greater than could have been claimed by the entity filing separately, if the entity from whom the carryforward was from a year in which the entity did not file a return on a disregard basis. (Federal tax law allows a business to file a form electing to be classified as an entity to be disregarded as separate from its owner. In that case, the income and expenses of the disregarded entity are reported on the tax return of the owner of the entity. This applies, for example, to a single-person limited liability company or a limited liability company with one business as a member.

In the 2003-04 session, this provision would have been added by House Bill 4570, introduced by then-Representative William J. O'Neil, and was part of the tax loophole package of legislation that accompanied Governor Granholm's FY 2004 Executive Budget Recommendation. At the time, the Department of Treasury contended that this provision served to prevent a firm with an unused SBT loss or credit obtained while filing separately from using up that loss or credit faster by filing a joint return with an affiliate in a later year.

Penalties

The bill would specify that interest and penalties imposed under the act would not be assessed against a taxpayer in the tax year during which the changes made by the bill become effective if an underpayment is due to the changes made by the bill regarding the credit and loss carryforward for disregarded entities, "business income" and the federal domestic production activities deduction, or the small business credit.

FISCAL IMPACT:

A fiscal analysis is in process.

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