Legislative Analysis

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COMPREHENSIVE TAX PROPOSAL

House Bills 4361 & 4362 (Substitutes H-1)
Sponsor: Rep. Jud Gilbert, II
Committee: Tax Policy

Complete to 4-26-11

A SUMMARY OF PROPOSED SUBSTITUTES H-1 FOR HOUSE BILLS 4361 & 4362

BRIEF SUMMARY: House Bill 4361 would amend the Income Tax Act to implement a comprehensive set of tax changes. The substitute represents an alternative to the original proposal made by the Snyder Administration. The bill divides the Income Tax Act into two parts: Part One contains changes in the existing personal income tax, and Part Two, which is entirely new, contains provisions for a corporate income tax. House Bill 4362 would amend the Michigan Business Tax Act so that MBT credits awarded through 2011 could stay in place through the life of the agreements.

The tax changes consist of:

- Eliminating the Michigan Business Tax (MBT). Under House Bill 4362, the act would be repealed when the last credit or carryforward based on a credit was claimed. Taxpayers could choose to continue to file under the MBT to keep certain "certificated credits."

- Imposing a new 6% corporate income or profits tax with no credits, except for the small business credit. This would apply to C corporations only, and would be effective January 1, 2012. Other businesses would only pay taxes on business income passed through to individuals -- they would pay under the individual income tax.

- Keeping the current 4.35% income tax rate until January 1, 2013, and then freezing the income tax rate at 4.25%. (Under current law, the income tax rate is 4.35%. Beginning October 1, 2011, the rate is scheduled to be reduced by 0.1 percentage points each year until the rate reaches 3.95%; then the rate is scheduled to be reduced to 3.9% effective October 1, 2015. Under the proposal, these reductions would not take place.)

- Eliminating, limiting, and restructuring various income tax exemptions, including the exemption for pension/retirement income and the state earned income tax credit. These two changes have the largest fiscal impact. For the complete list, see the descriptions beginning on Page 5, and the table on the last page. The change in treatment of retirement income means that a larger portion of retirement income would be subject to income tax. The changes include:

- Replacing the earned income tax credit (EITC) for low-income workers with a $25 per minor child tax credit.
- Reducing the exemption for retirement income (from both public and private pensions), with the amount of the exemption to depend on a taxpayer's age. The current exemption would remain unchanged for those born before 1946; would be reduced for those born in 1946 and through 1952; and reduced further for those born after 1952. (See Page 5)
- Phase-out the $3,700 per person personal exemption, beginning at $75,000 of household resources for single taxpayers and $150,000 for joint taxpayers, and eliminate the $2,300 per person special exemption for senior citizens and recipients of unemployment compensation.
- Base the amount of the homestead property tax credit on income (rather than age) and phase out eligibility for the credit at lower income levels than is currently the case (making fewer eligible). Those with "total household resources" of over $50,000 would no longer be eligible.

FISCAL IMPACT: In total, these tax changes would reduce revenue by an estimated $453.8 million in FY 2011-12 and decrease revenue by $192.0 million in FY 2012-13.

However, these tax changes would ***increase*** General Fund/General Purpose (GF/GP) revenue by an estimated $225.7 million in FY 2011-12 and $465.0 million in FY 2012-13 while ***reducing*** reduce School Aid Fund (SAF) revenue by an estimated $679.5 million in FY 2011-12 and $657.0 million in FY 2012-13.

Table 1, below, includes the estimated fiscal impact of the proposal for tax changes. The fiscal impact only includes honoring existing certificated credits and does not include credits to be awarded in 2011. A more detailed chart is found on the last page of the summary.

Table 1
Summary of Estimated Fiscal Impact of HB 4361 (H-1) & HB 4362 (H-1)
Effective Date January 1, 2012 (millions of dollars)

Business Tax Related	**FY 2011-12 Estimates**	**FY 2012-13 Estimates**
Repeal MBT	(2,170.0)	(2,024.4)
Partial Year MBT	900.2	0.0
6% Corporate Income Tax (Only C Corps)	509.8	811.8
Financial Institutions Tax	27.7	43.9
Honor Existing Firm-Specific Credits	(293.0)	(500.0)
Net Business Tax Change	**(1,025.3)**	**(1,668.7)**
Income Tax Related		
Individual Income Tax Changes	571.5	1,476.7
Net Income Tax Change	**571.5**	**1,476.7**
Total Tax Changes	**(453.8)**	**(192.0)**
GF/GP	225.7	465.0
SAF	(679.5)	(657.0)

DETAILED SUMMARY:

MBT and Corporate Income Tax Changes

The bill would repeal the Michigan Business Tax and replace it with a 6% corporate income or profits tax with no credits, except for the small business credit. Qualified small businesses are eligible to pay an alternate tax equal to 1.8% of adjusted business income. The tax base for the new tax would be apportioned to Michigan based solely on a sales factor and is not to be based on property, payroll, or any other factor, notwithstanding the Multistate Tax Compact Act.

(Another bill, House Bill 4479, would amend the Multistate Tax Compact Act to say that the apportionment provisions of the MBT or the new CIT would take precedence over apportionment provisions in the MTCA.)

The business tax on insurance companies and financial institutions would not be fundamentally changed from current law.

Unlike the MBT, the corporate income tax would apply only to C corporations and not other business types. Credits that have already been awarded under the MBT, such as MEGA, brownfield redevelopment, renaissance zone, film production, battery/photovoltaix, and other credits would be retained for the duration of the agreements, but no additional credits would be awarded after 2011.

Businesses that are not C corporations would pay taxes only through the individual income tax (on passed-through income), but the apportionment formula that individuals affiliated with multi-state firms would use for determining business income would be based solely on a sales factor rather than, as is now the case, equally on sales, property, and payroll.

Combined, the MBT and corporate income tax changes proposed in the bill would reduce business taxes by an estimated $1.03 billion in FY 2011-12 and $1.67 billion, which is an 82% reduction, on a full year basis in FY 2012-13.

As a background, the MBT is a tax on all businesses with apportioned gross receipts above $350,000 with business activity in Michigan. The MBT has two main components to its tax base: (1) business income or net profit and (2) modified gross receipts (gross receipts less purchases from other firms, such as inventory, depreciable assets, and materials and supplies). Business income is taxed at 4.95% and modified gross receipts component is taxed at 0.8%.

In addition, the MBT includes many credits and a surcharge. The surcharge (except for insurance companies and financial institutions) is 21.99% of taxpayer's MBT liability after apportionment but before credits and is limited to $6 million per taxpayer per tax year. For financial institutions, the MBT surcharge is 23.4%, but insurance companies are not subject to the surcharge.

The MBT was originally designed to be revenue neutral with the SBT and a personal property tax (PPT) cut and to reimburse the SAF for the state and local PPT exemptions,

which totaled $479 million in FY 2008-09. The PPT is primarily a local tax levied on businesses for personal property such as equipment, machinery, furniture, and fixtures. The MBT property tax related legislation exempted industrial personal property from the 6 mill state education tax, the industrial facilities tax portion of the 18 school operating mills, and the 18 school operating mills. It also exempted commercial personal property from up to 12 of the school operating mills.

As noted earlier, under this proposal, credits that have already been awarded under the MBT, such as MEGA, brownfield redevelopment, renaissance zone, film production, battery/photovoltaix, and other credits would be retained for the duration of the agreements, but no additional credits would be awarded after 2011.

A brief description of the temporarily retained credits follows.

- MEGA. Numerous credits for new or expanding firms based on additional payroll and heath care costs or additional business activity costs associated with an expansion or new location.

- Brownfield Redevelopment. Credit for some of the costs of demolition, construction, restoration, or alteration of buildings located in Brownfield development zones.

- Renaissance Zone. Credit against the MBT for businesses located within one of the more than 150 renaissance zone boundaries.

- Film Production Credits. Credits for film production expenditures: 40 - 42% refundable credit for direct production expenditures (including, but not limited to, compensation payments to producers, directors, writers, and actors), 30% credit for qualified personnel expenditures (below the line personnel, such as technical crew, who were not residents of Michigan for at least 60 days before approval of the agreement), 25% investment film infrastructure credit, and a 50% qualified job training credit.

- Battery Credits. A variety of credits are issued for battery related activity: pack engineering, integration and assembly credits, vehicle engineering credit, advanced battery technologies credit, and battery cell manufacturing credits.

- Other Credits. Historic, farmland, and workers disability credits. The historic preservation credit provides a credit up to 25% of expenditures for the restoration of a qualified historic site. The farmland preservation credit provides property tax relief for corporate farms. The workers' disability supplemental benefit credit provides for 100% of the supplemental cost of living payments made to persons injured between September 1965 and December 1979.

Generally speaking, <u>under House Bill 4362</u>, a firm that has been approved to receive, has received, or has been assigned a certificated credit could elect to continue to file under the MBT rather than the new corporate income tax to claim the credit. Once the firm has made that choice it would continue to file under the MBT until the certificated credit or any carryforward is used up. The firm's MBT tax liability would be determined by

subtracting the total amount of certificated credits from the greater of (1) the firm's MBT tax liability before applying the credits; or (2) the firm's liability under the new corporate income tax, as if the firm was subject to that tax (less any net operating loss that would have been carried over if the firm had been subject to the CIT in the immediately preceding tax year).

However, a firm claiming a credit under Section 433 of the MBT, for businesses located in a renaissance zone, could determine its liability only by subtracting the total amount of certificated credits from MBT liability before the subtraction of credits.

Personal Income Tax Changes

The income tax changes proposed by this proposal would increase the income tax by an estimated $571.5 million in FY 2011-12 and $1.48 billion in FY 2012-13. The proposed changes are as follows.

- Keep the current 4.35% income tax rate until January 1, 2013, and then freeze income the tax rate at 4.25%. Under current law, the income tax rate is 4.35%. Beginning October 1, 2011, the rate is scheduled to be reduced by 0.1 percentage points each year until the rate reaches 3.95%; then the rate is scheduled to be reduced to 3.9% effective October 1, 2015. Under the proposal, these reductions would not take place.

- Restrict and restructure the retirement exemptions. Under current law, Social Security, military, federal, state and local government retirement/retirement income is fully exempt. Private retirements are exempt up to $45,120 single/$90,240 joint (TY 2010) – these levels are indexed to inflation. In Michigan, defined benefit plans, IRAs, and annuities are fully exempt. Also, 401(k) distributions attributable to employer contributions or to employee contributions that are matched by the employer are exempt, but distributions attributable to employee contributions that are not matched by the employer are currently subject to the state income tax, subject to the private retirement limits. In addition, 401(k)s with no employer match are not considered retirements and therefore are completely subject to the income tax.

  Under this proposal, the treatment of retirement income would depend upon a taxpayer's age (and the age of the older spouse for a joint return), as follows:

  ** Taxpayers born before 1946 would continue to have the same treatment of retirement and Social Security income as in current law, and could claim the personal exemptions for which they are eligible.

  ** Taxpayers born in 1946 and through 1952 could take an exemption of $20,000 for a single return and $40,000 for joint return against retirement income until age 67, and then could take that same exemption amount against all types of income. In addition, these taxpayers at any age could claim personal exemptions for which they were eligible and could exempt Social Security income. However, the $20,000/$40,000 exemption would not be available where total household resources exceeded $75,000 for a single return or $150,000 for a joint return.

** Taxpayers born after 1952 would receive no exemption for retirement income until reaching age 67, except for the Social Security exemption. Then, they would have a choice between (1) the $20,000/40,000 exemption against all types of income, with no personal exemptions and with no additional exemption for Social Security, or (2) continuing the exemption for Social Security, along with the personal exemptions for which they were eligible. However, the $20,000/$40,000 exemption would not be available where total household resources exceeded $75,000 for a single return or $150,000 for a joint return.

- Eliminate the dividends, interest, capital gains exemption received by seniors, but only for seniors born after 1945. Under current law, senior investment income up to $10,058 single/$20,115 joint (TY 2010, indexed to inflation) is exempt. This exemption would continue to apply to seniors born in 1945 and earlier.

- Eliminate the $2,300 (TY 2010, indexed to inflation) special exemptions for seniors and individuals with unemployment compensation equal to or greater than 50% of their AGI (adjusted gross income, Michigan's starting point from federal return).

- Personal exemption phase-out. Under current law, $3,700 (TY 2011, indexed to inflation) is exempt from AGI for each personal exemption claimed on the federal income tax return. The personal exemption increases in $100 increments based on inflation. The bill would phase-out the personal exemption for single taxpayers between the income range of $75,000 and $100,000 and for married taxpayers between the income range of $150,000 and $200,000. Taxpayers with incomes above the upper bound would receive no personal exemption. The formula for the phasing out of the exemption (single filer) is:

  Personal Exemption multiplied by: $\frac{\$100{,}000 \text{ minus total household resources}}{\$25{,}000}$

- Eliminate child deduction. The child deduction provides a $600 subtraction from AGI for each dependent child age 18 or younger.

- Eliminate miscellaneous subtractions. The bill would eliminate subtractions for political contributions; prizes won from bingo, raffle, or charity games; losses from the disposal of property; income from gas and oil royalty interest; certain distributions from IRAs used to pay higher education expenses; qualifying distributions from a retirement or retirement plan that is contributed to a charitable organization.

- Eliminate the city income tax credit. The city income tax credit is a non-refundable credit to partially offset the city income tax liability (levied in 22 cities). In TY 2008, 823,600 credits were allowed, and the average credit was $38.

- Eliminate the public contributions credit. The public contributions credit is a non-refundable credit equal to 50% of the amount contributed up to a maximum credit of $100 for single ($200 for joint) returns. Public contributions include gifts to

Michigan colleges and universities, public libraries, museums, and public broadcasting stations. In TY 2008, 273,300 credits were allowed, and the average credit was $90.

- Eliminate the community foundations credit. The community foundations credit is a non-refundable credit equal to 50% of the amount contributed up to a maximum credit of $100 for single ($200 for joint) returns. In TY 2008, 35,200 credits were allowed, and the average credit was $93.

- Eliminate the homeless shelter/food bank credit. The homeless shelter/food bank credit is a non-refundable credit equal to 50% of the amount contributed up to a maximum credit of $100 for single ($200 for joint) returns. The credit is for cash donations to qualifying homeless shelters, food banks, and food kitchens whose primary purpose is to provide accommodations or food to indigent persons. In TY 2008, 234,100 credits were allowed, and the average credit was $81.

- Eliminate the historic preservation credit. The historic preservation credit is a refundable and a non-refundable credit to rehabilitate historic sites and is equal to 25% of the qualified expenditures. In TY 2008, about 300 credits were allowed and the average credit was $4,581.

- Eliminate the college tuition and fees credit. The college tuition and fees credit is a non-refundable credit for resident taxpayers with AGIs of less than $200,000 and is equal to a percentage of tuition and fees. To qualify, the school must have certified that tuition and fees will not increase by more than the rate of inflation. The amount of the credit is the lesser of 8% of the tuition and fees paid or $375 per student. The credit cannot be claimed for more than 4 years for any one student. In TY 2008, about 83,000 credits were allowed and the average credit was $146.

- Eliminate the vehicle donation credit. The vehicle donation credit is a non-refundable credit to equal to 50% of the fair market value of certain automobile donations to qualified charitable organizations. The credit is limited to up to a maximum credit of $100 for single ($200 for joint) returns. In TY 2008, about 2,200 credits were allowed and the average credit was $56.

- Eliminate the individual or family development credit. Individuals or families whose income is 200% of the federal poverty level can establish accounts for qualified expenses and receive a nonrefundable credit equal to 75% of the contributions made to the account.

- Eliminate the adoption credit. The adoption credit provides refundable credit of up to $1,200 per child, to the extent that qualified adoption expenses exceed the amount allowed under the federal adoption credit. In TY 2008, about 600 credits were allowed, and the average credit was $1,241.

- Eliminate the stillbirth credit. This refundable credit is available to taxpayers who have been provided with a Certificate of Stillbirth. The credit is equal to 4.5% of the personal exemption amount, rounded to the closest $10 increment.

- Eliminate the earned income tax credit. The EITC is a refundable credit for working low income households equal to 20% of the federal EITC. The federal credit is equal to a percentage of the taxpayer's earned income based on the number of children in the household, up to a certain amount adjusted annually for inflation. In TY 2008, the maximum federal credit was $438 for taxpayers with no children; $2,917 for taxpayers with one child; and $4,824 for taxpayers with more than one child. Based on our sample of TY2009 state income tax data, there were 782,671 claimants and the total amount claimed was $336.7 million. The average credit was $430.20. Of the total claimants, 551,126 were from households with children under the age of 19. These claims totaled $308.4 million, which is an average of $559.50 per claim. This represents 70.4% of the total number of claims and 91.6% of the total dollar amount of claims. The remaining 231,545 claims were from households without children which totaled $28.4 million, or $122.46 per claim.

  Elimination of the EITC would increase revenue by an estimated $373.7 million for FY 2012-13. In recent years, a portion of the state earned income tax credit has been used to meet maintenance of effort (MOE) requirements for federal Temporary Assistance for Needy Families (TANF) dollars. Elimination of the credit would also eliminate this TANF MOE claim generated by the state EITC. Thus, other eligible state spending would need to be identified to ensure that MOE requirements were met.

- Taxpayers who are eligible for a federal EITC could, under this substitute proposal, claim a credit equal to $25 per minor child residing with the taxpayer.

- Homestead property tax credit (HSPTC) changes. For TY 2008, Michigan taxpayers with household income less than $82,650 may claim a property tax credit, and the computed credit is reduced by 10% for every $1,000 that household income exceeds $73,650. Under current law, the credit is equal to 60% of the amount by which property taxes (or 20% of rent for renters) exceed 3.5% of household income, up to a maximum of $1,200. For seniors and disabled filers, the credit is equal to 100% of the difference. Under the proposal, taxpayers that currently take the HSPTC with household income between $50,000 and $82,650 (roughly 268,500 filers) would no longer be able to take the credit.

  Under the proposal, the homestead credit would be altered as follows:

  ** A person would not be eligible if the taxable value of the homestead exceeded $135,000 (presumably a market value of $270,000).

  ** Taxpayers with total household resources above $50,000 could not claim the credit, and the credit would phase out for those with total household resources between $41,000 and $50,000.

  ** The credit would be equal to 100% of the amount by which property taxes (or imputed property taxes for renters) exceed 3.5% of total household resources for those with total household resources of $21,000 or less; and 96% for those with total household resources over $21,000 and up to $22,000. The percentage that

could be claimed would be reduced by 4% for each additional $1,000 in total household resources ending with those with total household resources of over $30,000 able to claim 60% of the amount by which property taxes exceed 3.5% of total household resources.

In TY 2008, about 453,200 senior credits were allowed and the average credit was $770. Also, 1,058,500 general credits were allowed and the average credit was $498.

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

Table 2
Detailed Estimates of the Fiscal Impact of HB 4361 (H-1) & HB 4362 (H-1)
Effective Date January 1, 2012 (millions of dollars)

	FY 2011-12 Estimates			**FY 2012-13 Estimates**		
Business Tax Related	**GF/GP**	**SAF**	**Total**	**GF/GP**	**SAF**	**Total**
Repeal MBT	(1,419.8)	(750.2)	(2,170.0)	(1,260.7)	(763.7)	(2,024.4)
Partial Year MBT	900.2	0.0	900.2	0.0	0.0	0.0
6% Corporate Income Tax (Only C Corps)	460.1	0.0	460.1	748.8	0.0	748.8
Financial Institutions Tax	27.7	0.0	27.7	43.9	0.0	43.9
Honor Existing Firm-Specific Credits	(293.0)	0.0	(293.0)	(500.0)	0.0	(500.0)
CIT "Option Tax"	24.7	0.0	24.7	38.0	0.0	38.0
MTC Fix (Ongoing Only) HB 4479	25.0	0.0	25.0	25.0	0.0	25.0
Net Business Tax Change	**(275.1)**	**(750.2)**	**(1,025.3)**	**(905.0)**	**(763.7)**	**(1,668.7)**
Income Tax Related						
Freeze Income Tax Rate at 4.25% effective Jan 1, 2013	170.0	0.0	170.0	213.5	0.0	213.5
Modify Public/Private Pension Exemption	177.4	47.5	224.9	269.3	73.5	342.8
Retain Military Pension Exemption	(4.1)	(1.0)	(5.1)	(7.3)	(0.5)	(7.8)
Phase-Out Pension Exemption High Incomes	4.1	1.0	5.1	6.2	1.6	7.8
Repeal Senior Interest, Dividend Exemption Age Based	3.2	0.8	4.1	4.9	1.3	6.2
Eliminate Some Special Exemptions	6.7	2.1	8.8	40.9	0.0	40.9
Phase-Out Personal Exemption	41.4	13.0	54.4	63.2	19.7	82.9
Eliminate Child Deduction	0.0	0.0	0.0	57.0	0.0	57.0
Eliminate Miscellaneous Subtractions	28.1	7.2	35.4	42.9	11.0	53.9
Eliminate Non-refundable Credits						
City Income Tax Credit	26.3	0.0	26.3	36.7	0.0	36.7
Public Contributions Credit	20.3	0.0	20.3	28.1	0.0	28.1
Community Foundations Credit	3.0	0.0	3.0	4.1	0.0	4.1
Homeless Shelter/Food Bank Credit	16.5	0.0	16.5	22.8	0.0	22.8
Historic Preservation Credit	0.0	0.0	0.0	0.0	0.0	0.0
College Tuition Credit	7.1	0.0	7.1	9.8	0.0	9.8
Vehicle Donation Credit	0.8	0.0	0.8	1.0	0.0	1.0
Individual or Family Development Credit	0.0	0.0	0.0	0.0	0.0	0.0
Eliminate Refundable Credits						
Adoption Credit	0.0	0.0	0.0	1.0	0.0	1.0
Stillbirth Credit	0.0	0.0	0.0	0.0	0.0	0.0
Modify EITC						
Eliminate 20% Refundable EITC	0.0	0.0	0.0	373.7	0.0	373.7
Provide $25 Refundable Credit per Minor Child	0.0	0.0	0.0	(25.0)	0.0	(25.0)
Modify Homestead Property Tax Credit	0.0	0.0	0.0	227.5	0.0	227.5
Net Income Tax Change	**500.8**	**70.7**	**571.5**	**1,370.0**	**106.7**	**1,476.7**
Total Tax Changes	**225.7**	**(679.5)**	**(453.8)**	**465.0**	**(657.0)**	**(192.0)**

Source: Department of Treasury and House Fiscal Agency