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BILL ANALYSIS

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Senate Bill 1127 (as reported without amendment)
Sponsor: Senator Goeff Hansen
Committee: Government Operations

Date Completed: 11-21-16

RATIONALE

Concerns have been raised regarding the collection of city income taxes from individuals whose employers do not withhold the taxes. The City Income Tax Act allows a city to adopt an ordinance that imposes a tax on the income of residents of the city, on the earnings of nonresidents related to work or business activities conducted in the city, and on a corporation's Federal taxable income earned in the city. Currently, 22 cities in Michigan have a city income tax. The tax rate typically is 1.0% for residents and corporations and 0.5% for nonresidents, but different rates apply in Detroit, Grand Rapids, Highland Park, and Saginaw. If a city imposes the tax, an employer that is doing business or maintaining an establishment within the city is required to withhold the tax from employees' compensation. If an employer does not do business or maintain an establishment within the city, but employs individuals who are subject to the tax, the employees are responsible for remitting the tax to the city, unless the business voluntarily withholds it. Apparently, however, many employees fail to pay the tax, which means that the city does not collect that revenue unless enforcement efforts are made. To address this situation, it has been suggested that the Act should impose what is sometimes called "reverse commuter withholding", which requires a business that is outside of a city that imposes an income tax to withhold the tax from its employees who are residents of the city.

CONTENT

The bill would amend the City Income Tax Act to provide that an employer whose employee was a resident of a city that imposed an income tax would be subject to the city's withholding provisions for that employee, even if the employer were not doing business in the city or did not maintain an establishment there. The bill would make an exception for an employer that paid $500,000 or less in total wages in the prior year and had fewer than 10 employees.

The Act sets forth a uniform city income tax ordinance that must be adopted by a city choosing to impose an income tax. (For a city income tax adopted after January 1, 1995, voter approval is required.) The Act states that the uniform city income tax ordinance does not apply to a person or corporation as to whom or which it is beyond the power of the city to impose the tax. Under the bill, this would apply except as provided below.

The bill specifies that an employer located in the State that had an employee who was a resident of a city that imposed a city income tax would be subject to that city's withholding provisions for that employee even if the employer were not doing business in the city or did not maintain an establishment in the city. If the employer paid $500,000 or less in total wages in the previous year, however, and had fewer than 10 employees, the employer would not be required to withhold taxes from that employee under the city's withholding requirements.

The bill also would amend the uniform city income tax ordinance to reflect the proposed withholding requirement.

The Act allows a city that imposes an income tax to enter into an agreement with the Department of Treasury for the Department to administer, enforce, and collect the city income tax on behalf of the city. The bill also provides that, if a city entered into such an agreement, the Department would have to administer, enforce, and collect the city income tax on behalf of the city pursuant to the revenue Act. If the provisions of that Act and the City Income Tax Act or any ordinance of the city conflicted, this requirement would apply.

MCL 141.506 et al.

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

Cities that impose an income tax do so in order to generate revenue for essential services, such as police and fire protection, roadway repairs, public lighting, and emergency medical services. When the tax is not paid or collected, all residents of the city are affected. This is unfair to those who work in the city and whose taxes are withheld by their employers, while some residents who work outside of the city receive the same services without paying for them, or without paying voluntarily. Although these people are liable for the paying the city income tax, unless their employers choose to withhold it, there are scofflaws who might slip through the cracks or require the city to spend considerable resources on enforcement efforts. In Grand Rapids, for example, after identifying residents who have not filed city tax returns, the city sends them two notices, creates a substitute return if there is no response, and then sends an assessment. The city will send a person up to a half-dozen tax bills and then pursue criminal prosecution if he or she continues to ignore them. While garnishing employees' wages for unpaid taxes might be considered an option, that remedy would be expensive and complicated, and it could clog the courts; garnishment also could prove more burdensome to employers than withholding would be.

Withholding by employers is the most effective way to ensure that taxes are collected. Compliance with Federal and state income tax laws evidently is about 98%, because the laws compel employers to withhold and remit their workers' taxes. Conversely, in the City of Detroit, for example, compliance was 67% in 2015, according to Committee testimony. When the City Income Tax Act was enacted in 1964, it might have made sense to impose the withholding requirement only on employers doing business in a city with an income tax. At that time, the proportion of residents working in the city where they lived was much higher than it is today. Now, the percentage of individuals who work outside their city of residence reportedly is 64% in Grand Rapids, 65% in Lansing, 67% in Detroit, and 90% in Pontiac.

The withholding requirement under the bill would ensure that cities received the tax revenue they need and are legally entitled to, without imposing a hardship on employers. Many, if not most, of the businesses that would be affected already contract with a third party vendor to handle their payroll and withhold Federal and State taxes. Many large employers--including, reportedly, Aramark, Fiat Chrysler, Ford Motor Company, and the University of Michigan--already withhold and remit city income taxes regardless of whether they are or are not required to do so under the Act. Many small businesses do so as well. If an employer is voluntarily withholding city income taxes, however, an employee can tell it not to do so on his or her behalf; although the employee remains liable for the tax, there is no guarantee that he or she will pay it, or will pay it without compliance action.

Some individuals, on the other hand, may struggle to make quarterly estimated payments or an annual lump-sum payment, and would prefer to have their employer withhold the taxes. The bill would provide relief to these workers, as well as protect an important revenue source for cities.

Opposing Argument

The proposed withholding mandate would be burdensome and costly to employers. Many businesses do not contract with a third party for payroll services, and actually perform withholding functions manually. Even employers that use automated systems would incur reprogramming expenses. In some cases, the cost to comply could be higher than the amount of taxes withheld. For all affected employers, compliance could be challenging due to the nature of the city income tax, with rates that can vary from one city to the next, and different rates for residents and nonresidents. Also, a pool of workers can come from multiple cities, employees can move from one city to the next at any given time, and workers can split their time between different cities.

Furthermore, regardless of whether employers use a third party vendor, they would be subject to enforcement action by a city, or multiple cities. Employers could be forced to undergo audits and, if they made a mistake, could be liable for penalties. Some cities evidently have a history of hiring third parties to perform audits, and the bill would give city treasury departments an incentive to go on "fishing expeditions".

Essentially, the bill would require employers to be tax collectors for the cities that impose an income tax. This mandate could be legally questionable if a firm received no services from a city, had no business activity there, and maintained no facility in the city--and received no benefit from complying. At the very least, employers required to withhold taxes should be entitled to an administrative collection fee.

In addition, the bill could harm individuals by discouraging employers from hiring residents of a city that imposes an income tax. This would undermine efforts that are being made to provide jobs for people who live in economically challenged cities. For example, according to Committee testimony, 170 residents of Flint are bused to jobs in Livingston County. Also, small businesses could be discouraged from growing, in order to qualify for the exemption for employers with fewer than 10 workers and $500,000 or less in total wages.

Under the law, if an employee is subject to a city income tax and his or her employer does not withhold the tax, it is the employee's obligation to pay the tax. Also, it is the responsibility of the city to enforce its income tax ordinance. Rather than shifting the burden to businesses, cities should make greater efforts to collect their own taxes.

Response: Regarding the alleged challenge to employers due to the nature of the city income tax, businesses with employees or sites in multiple states already must comply with complicated withholding requirements. Having to withhold city income taxes would not be more complex.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bill would increase the revenue of cities that levy a city income tax by an unknown amount and increase the administrative costs of the Michigan Department of Treasury and cities that levy a city income tax by a minimal amount. Local revenue would increase to the extent that the bill resulted in city income tax withholding payments from residents with city income tax liability but who currently are not subject to withholding and do not report or pay taxes on income earned outside the city limits. According to the Department of Treasury, total revenue from local income taxes was approximately $463.8 million in 2013. Assuming that 70% of city income tax revenue is paid by city residents, if the bill increased residents' withholding and thus tax payments by 1.0%, the estimated increase in city income tax revenue would be $3.2 million per year. A 5.0% increase in withholding on residents would increase city income tax revenue by approximately $16.2 million annually. The 22 cities that levy an income tax and their 2013 income tax collections are shown in the table below. The Department of Treasury and cities that levy an income tax would have increased administrative costs to inform employers of the withholding obligations imposed by the bill, and to establish and implement payment procedures.

City Income Tax Collections for Tax Year 2013 (Thousands of Dollars)	
City	Collections
Albion	$953
Battle Creek	15,953
Big Rapids	2,121
Detroit	252,951
Flint	13,404
Grand Rapids	77,297
Grayling	444
Hamtramck	1,871
Highland Park	2,908
Hudson	395
Ionia	2,415
Jackson	7,857
Lansing	34,124
Lapeer	2,658
Muskegon	7,667
Muskegon Heights	970
Pontiac	9,598
Port Huron	6,671
Portland	644
Saginaw	12,406
Springfield	812
Walker	9,653
Total	$463,772
Source: Department of Treasury	

Fiscal Analyst: Elizabeth Pratt

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