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BILL ANALYSIS

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Senate Bills 748 and 750 (as enacted)

PUBLIC ACTS 38 & 39 of 2018

Sponsor: Senator Jack Brandenburg (S.B. 748)
Senator Marty Knollenberg (S.B. 750)
Senate Committee: Finance
House Committee: Tax Policy

Date Completed: 3-1-18

RATIONALE

The Federal Tax Cut and Jobs Act, which took effect on December 22, 2017, amended the Internal Revenue Code to revise tax rates and credits for United States taxpayers. One of the revisions reduces the personal exemption rate to $0. It is widely believed that this change would have negated the ability of Michigan taxpayers to claim personal exemptions on State and city income tax returns. Michigan's Income Tax Act and City Income Tax Act allowed a taxpayer to claim a personal exemption based on a calculation that depended on the number of exemptions or dependency exemptions allowable on the taxpayer's Federal income tax return. Because taxpayers will not be claiming a Federal personal exemption, which has zero value, many believed that taxpayers therefore would have been unable to claim Michigan's personal exemption, effectively increasing the amount of taxes they owed.

In addition, some believed that Michigan taxpayers should be given tax relief, since the State has experienced economic growth over the last few years.

In order to remove uncertainty surrounding Michigan's personal exemption and reduce individuals' tax liability, it was suggested that amendments should be enacted to increase as well as preserve the State's personal exemption.

CONTENT

Senate Bill 748 amended Part 1 of the Income Tax Act to do the following:

-- **Specify the number of personal and dependency exemptions a taxpayer is allowed, and delete language under which the number of exemptions depended on the number allowed on a taxpayer's Federal return.**
-- **Increase the personal exemption from the previous $4,000 to $4,050 for the 2018 tax year, $4,400 for the 2019 tax year, $4,750 for the 2020 tax year, and $4,900 for the 2021 tax year.**
-- **Require the inflation-based adjusted amount of the exemption to be increased by an additional $600, beginning with the 2022 tax year.**
-- **Revise the deduction for contributions to and distributions from an ABLE savings account, and interest earned on contributions to education savings accounts.**

Senate Bill 750 amended the City Income Tax Act to do the following:

-- **Allow a taxpayer deductions for the full personal and dependency exemptions authorized by Part 1 of the Income Tax Act, instead of under the Internal Revenue Code, or a deduction of a minimum of $600 for each personal and dependency exemption under the rules for determining exemptions and dependents under Part 1, instead of under the Internal Revenue Code.**

- **-- Allow a city to provide an exemption of a certain amount for a person with respect to whom a deduction under Part 1 of the Income Tax Act, instead of the Internal Revenue Code, is allowable to another taxpayer and is therefore not considered to have a personal exemption.**

The bills took effect on February 28, 2018.

Senate Bill 748

Personal Exemption

Part 1 of the Income Tax Act imposes a tax at the rate of 4.25% on the taxable income of individuals. "Taxable income" means adjusted gross income as defined in the Internal Revenue Code (IRC), subject to a number of additions and deductions. In addition to these adjustments, the Act previously provided for a personal exemption multiplied by the number of personal or dependency exemptions allowable on the taxpayer's Federal income tax return under the IRC, to be subtracted in the calculation that determines taxable income.

The bill deleted reference to the number of exemptions allowable on a Federal tax return. Instead, the number of personal and dependency exemptions allowed must be determined as follows:

-- Each taxpayer may claim one personal exemption; however, if the taxpayer and his or her spouse do not make a joint return, the taxpayer may claim a personal exemption for the spouse if the spouse, for the calendar year in which the taxpayer's taxable year begins, does not have any gross income and is not the dependent of another taxpayer.
-- A taxpayer may claim a dependency exemption for each individual who is a dependent of the taxpayer for the tax year.

The bill repealed Section 30e of the Act, which defined "dependent" as an individual for whom the taxpayer could claim a dependent exemption on the taxpayer's Federal income tax return under the IRC. Under the bill, "dependent" means a dependent as defined in Section 152 of the IRC. (Under Section 152, "dependent" means a "qualifying child" or a "qualifying relative", as those terms are defined in that section.)

Previously, an individual with respect to whom a deduction under the IRC was allowable to another Federal taxpayer during the tax year was not considered to have an allowable Federal exemption for purposes of the Act's personal exemption, but could subtract $1,500 in the calculation that determines taxable income. Under the bill, instead, an individual for whom a deduction under the Act's personal exemption is allowable to another taxpayer during the tax year is not entitled to a personal exemption but may subtract $1,500.

Exemption Amount

Section 30 of the Act sets the amount of the personal exemption at $3,700, and requires the amount to be adjusted by an increase of $100 when changes in the consumer price index trigger an increase, according to a formula in the Act. Section 30a of the Act specifies that the amount of the exemption is $4,000, or the inflation-adjusted amount required by Section 30, whichever is greater.

Based on these provisions, the amount of the personal exemption previously was $4,000. The bill amended Section 30a to increase the amount as follows:

-- For the 2018 tax year, $4,050.
-- For the 2019 tax year, $4,400.
-- For the 2020 tax year, $4,750.
-- For the 2021 tax year, $4,900.

As currently required, the size of the exemption must be the amount set in Section 30a or the inflation-adjusted amount required by Section 30, whichever is greater. The bill amended Section 30 to provide that, for the 2022 tax year and each subsequent tax year, the adjusted amount must be increased by an additional $600.

(Therefore, if the adjusted amount calculated under Section 30 were $4,400 in tax year 2022, the addition of $600 would increase the personal exemption to $5,000 for that tax year. In the following year, if the adjusted amount calculated under Section 30 were $4,500, the addition of $600 would result in a personal exemption of $5,100 in the 2023 tax year.)

Exempt Dependent

Under the bill, an individual with respect to whom a deduction is allowable to another taxpayer during the tax year is not considered to have an allowable exemption for purposes of the Act's personal exemption calculation, and is exempt from the income tax and not required to file a return, if the person has an adjusted gross income of $1,500 or less. Previously, this applied to a person with respect to whom a deduction under the IRC was allowable to another Federal taxpayer.

Deductions

Previously, to the extent *not deducted* in determining adjusted gross income, a taxpayer was allowed to deduct interest earned on contributions to the taxpayer's ABLE savings account, as well as distributions that were qualified withdrawals from an ABLE savings account to the designated beneficiary of the account. Under the bill, a taxpayer may deduct the interest and distributions to the extent *included* in adjusted gross income.

The bill also repealed Section 30f of the Act, which allowed a taxpayer to deduct interest earned on contributions to the taxpayer's education savings accounts to the extent not deducted in determining adjusted gross income, and to deduct distributions that were qualified withdrawals to the extent included in adjusted gross income. Under the bill, a taxpayer may deduct both the interest and the distributions to the extent included in adjusted gross income.

Senate Bill 750

Under the City Income Tax Act, a city may adopt an ordinance to impose and collect a tax on the income of residents and on the earnings of nonresidents related to work or business activities conducted in the city. Previously, an individual taxpayer in computing his or her taxable income was allowed deductions for the full personal and dependency exemptions authorized by the Internal Revenue Code, or a deduction of a minimum of $600 for each personal and dependency exemption under the rules for determining exemptions and dependents under the Code.

The bill, instead, specifies that an individual taxpayer is allowed deductions for the full personal and dependency exemptions authorized by Part 1 of the Income Tax Act or a deduction of a minimum of $600 for each personal and dependency exemption under the rules for determining exemptions and dependents under Part 1 of the Act.

Under the bill, a city may provide for either an exemption from the tax levied under the City Income Tax Act if a person's adjusted gross income for the tax year is less than an amount specified by the ordinance, or an exemption in an amount to be specified by the ordinance, for a person with respect to whom a deduction under Part 1 of the Income Tax Act is allowable to another taxpayer during the tax year and is therefore not considered to have a personal exemption under the provisions above.

Previously, the City Income Tax Act allowed an exemption from the city income tax for a person with respect to whom a deduction under the Internal Revenue Code was allowable to another Federal taxpayer during the tax year.

MCL 206.30 et al. (S.B. 748)
141.631 (S.B. 750)

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

With the Tax Cut and Jobs Act reducing the Federal personal exemption to $0, there was widespread concern that Michigan taxpayers also would have their personal exemptions reduced to $0 for State and city tax returns. Although some argued that, under a different interpretation, Federal law would not have prevented a Michigan taxpayer from claiming his or her personal exemption, it is important that the State have an unambiguous tax structure. The bills address this situation by explicitly retaining the personal exemption for State and city income taxes, without reference to the Federal exemption. The solution provides certainty for taxpayers.

Supporting Argument

The Tax Cut and Jobs Act's reduction, and effective elimination, of the Federal personal exemption, and, consequently, Michigan's personal exemption, would have resulted in a tax increase for all Michigan residents who pay the income tax. If the State had taken no action, the Department of Treasury estimated that the removal of personal exemptions would have cost a family of four $680. According to Senate Finance Committee testimony, the Federal changes would have resulted in a tax increase of almost $1.5 billion.

A tax increase of this magnitude would have been regressive, and would have created an unacceptable financial burden on Michigan taxpayers. The bills prevent the inadvertent tax increase for Michigan taxpayers by ensuring that they may continue to receive personal exemptions.

Supporting Argument

Michigan has seen great economic improvements during the difficult circumstances present over the last decade. According to the Governor's office, 540,000 private-sector jobs have been created since December 2010; 122,800 manufacturing jobs have been created since 2010, the most in the United States; Michigan's income growth rate since 2010 is the sixth highest in the nation; and the State has seen six consecutive years of population growth and eight years of unemployment reduction. The State's January 2018 Consensus Revenue Agreement estimates that wage and salary employment will continue to increase over the next three years, and that the unemployment rate will either remain consistent or decrease during that time. The report also projects combined General Fund and School Aid Fund revenue to increase through 2020.

Even though the Michigan economy has improved considerably over the last decade, Michigan taxpayers have not received significant tax relief in many years. The bills will reduce the burden on individual taxpayers, build on the positive economic momentum the State has generated, and encourage further taxpayer spending and economic development.

Legislative Analyst: Drew Krogulecki

FISCAL IMPACT

Senate Bill 748

The bill will reduce General Fund and School Aid Fund revenue from previously forecasted amounts by an unknown but significant amount in fiscal year (FY) 2017-18 and FY 2018-19, depending on when the bill's changes are implemented, by approximately $143.1 million in FY 2019-20, by approximately $181.9 million in FY 2020-21, and by approximately $175.0 million in each subsequent fiscal year.

The reduction in revenue during FY 2017-18 and FY 2018-19 will depend on when the bill is implemented. If the changes are implemented on April 1, 2018, revenue will be reduced by approximately $7.5 million in FY 2017-18 and approximately $74.0 million in FY 2018-19.

Under current law, approximately 23.8% of gross income tax revenue is earmarked to the School Aid Fund; therefore, that share of the total revenue reduction will lower School Aid Fund revenue. Consequently, if the bill lowers FY 2018-19 revenue by $74.0 million, School Aid Fund revenue will be reduced by $17.6 million, and the remaining $56.4 million in lower collections will reduce General Fund revenue.

In addition to the bill's impact relative to previous revenue forecasts, the bill will reduce General Fund and School Aid Fund revenue relative to previous law by approximately $1.1 billion in FY 2017-18, and approximately $1.4 billion in FY 2018-19. The revenue loss relative to previous law will increase in subsequent fiscal years. These additional losses reflect that the Federal tax reform legislation adopted in December 2017 would have effectively eliminated the personal exemption under the Michigan individual income tax, thereby increasing revenue by approximately $1.1 billion in FY 2017-18 and $1.4 billion in FY 2018-19 (and additional amounts in future fiscal years). The bill's changes regarding the definition of "dependent" are meant to effectively decouple Michigan's current individual income tax provisions for dependents from the Federal tax reform changes. However, previous revenue estimates did not account for the impact of Federal tax reform on Michigan's statutory tax provisions.

Consequently, while the bill's changes to the definition will lower revenue relative to previous law, the changes will not lower revenue relative to previous revenue estimates.

While the changes in the definition of "dependent" will not lower revenue below previous revenue estimates, the bill also increases the personal exemption amount above the levels that would exist if the bill only decoupled Michigan tax provisions from the Federal tax reform legislation. As a result, the bill also will reduce revenue relative to previously forecasted levels.

Senate Bill 750

The bill will have no impact on State revenue or expenditure. However, the bill will prevent an increase in local unit revenue resulting from the passage of Federal tax reform legislation in December 2017.

Without the enactment of this bill, the Federal tax reform legislation adopted in December 2017 would have effectively eliminated the personal exemption under city income taxes. Based on data from 2014, approximately 1.5 million exemptions were claimed with cities under their income tax ordinances (approximately 600,000 resident returns and approximately 900,000 nonresident and part-year resident returns). Statute requires city income tax ordinances to provide a personal exemption of at least $600 per allowable exemption. Several cities, including Battle Creek, Grayling, Hudson, Ionia, Portland, Saginaw, and Springfield, provide exemptions that exceed $600. Based on 2014 data, the increase in local unit revenue attributable to the Federal changes would have been approximately $9.9 million under previous law. Thus, the bill will prevent local unit revenue from increasing by $9.9 million per year.

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