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BILL ANALYSIS

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Senate Bill 1097 (as reported without amendment)
Sponsor: Senator Jack Brandenburg
Committee: Finance

Date Completed: 10-23-18

RATIONALE

The Federal Tax Cuts 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 limited the amount of interest expenses that may be deducted from corporate income. While this broadened the tax base, the Act included a rate reduction that offset this increase, resulting in a tax cut at the Federal level. For the purpose of calculating the State's Corporate Income Tax, Michigan generally defines taxable income as that term is defined under Federal law. Thus, with the Tax Cuts and Jobs Act, the State's tax base also was widened; however, there was no concurrent reduction in the tax rate. Therefore, Michigan businesses will see an increase in their State income tax liabilities. Some have argued that this increase was both unexpected and unintended, and that such an increase will affect Michigan's business environment. It has been suggested that the State disregard the interest expense modification made by the Tax Cuts and Jobs Act by "decoupling" Michigan statute from the Federal limitation.

CONTENT

The bill would amend the Income Tax Act to specify that Federal taxable income would have to be calculated as if Section 163(j) of the Internal Revenue Code was not in effect.

Under the Income Tax Act, "Federal taxable income" means taxable income as defined in Section 63 of the Internal Revenue Code, except that Federal taxable income must be calculated as if Sections 168(k) and 199 of the Code were not in effect. The bill also would include Section 163(j) in this list (see **BACKGROUND** for information on Section 163(j) of the Internal Revenue Code).

The bill is retroactive and would be effective January 1, 2018, and would apply to all business activity occurring after December 31, 2017.

MCL 206.607

BACKGROUND

The United States Corporation Income Tax Return (Form 1120) allows a corporation to deduct certain business interest from its tax liability. The Federal Tax Cuts and Jobs Act, enacted in 2017, limited the deduction for business interest. Michigan's Corporate Income Tax Annual Return (Form 4891) requires a taxpayer to include its Federal taxable income from Federal Form 1120 in order to calculate its tax liability to the State. Any changes made to the computation of Federal taxable income directly affects a Michigan taxpayer's taxable income for its tax liability to the State.

Section 163(j) of the Internal Revenue Code concerns limitations on deductions for interest on certain indebtedness. If Section 163(j) applies to any corporation for any taxable year, no deduction may be allowed under the Code for disqualified interest (as defined under the Code) paid or accrued by the corporation during the taxable year. The amount disallowed may not exceed the corporation's excess interest expense (as defined under the Code) for the taxable year. These provisions apply to any corporation for any taxable year if the corporation has excess interest expense for the taxable year, and meets a debt-to-equity ratio outlined under the Code.

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

Because of the way Michigan's Corporate Income Tax is tied to Federal law, the Tax Cuts and Jobs Act effectively raised Michigan businesses' tax liabilities to the State. According to testimony provided before the Senate Committee on Finance, the Act resulted in a 5.5% tax increase for businesses, which will result in $100.0 million in revenue. This tax increase was not discussed or debated by Michigan policymakers and occurred without any action taken by the State Legislature. A tax increase should be considered by State policymakers before taking effect. By decoupling Michigan statute from the relevant Internal Revenue Code provision, the bill would ensure that businesses do not see a tax increase without State deliberation.

Response: While the Tax Cuts and Jobs Act was broad in its reform, it generally was understood that the Act would result in an increase in tax liabilities for Michigan businesses. Specifically, a Michigan Department of Treasury Economic and Revenue Outlook document, dated January 11, 2018, reflects the Corporate Income Tax revenue increase. The State included this revenue in its upcoming budget, and generally understood the implications of the Act on Michigan businesses. For purposes of calculating a business's Corporate Income Tax liability, the Michigan Legislature made the decision to tie the deductibility of interest expenses to the Internal Revenue Code.

Supporting Argument

Foreign direct investment is critical to the Michigan economy. According to the Organization for International Investment, international companies employ 238,100 Michiganders and jobs provided by international companies grew by 63.8% over the last five years. The ability to deduct interest as an ordinary and necessary business expense encourages investment and expansion. If Michigan failed to enact Senate Bill 1097, the State would continue to limit interest deductibility, which would raise the cost of capital and increases taxes on Michigan employers. Other states, such as Georgia, Indiana, Tennessee, and Wisconsin, have enacted measures similar to the bill, effectively making those places more attractive for business. The bill would ensure that international companies had an incentive to invest across the State and that Michigan remained an attractive place for business.

Legislative Analyst: Drew Krogulecki

FISCAL IMPACT

The bill would reduce General Fund revenue by approximately $14.0 million in fiscal year (FY) 2017-18, $115.0 million in FY 2018-19, and by approximately $97.0 million in FY 2019-20, with the amount likely increasing in subsequent years as economic growth continues and the economy experiences higher interest rates.

Fiscal Analyst: David Zin

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