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BILL ANALYSIS



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Senate Bill 1170 (as introduced 11-8-18)
Sponsor: Senator Dave Hildenbrand
Committee: Finance

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CONTENT

The bill would amend the Income Tax Act to create Part 4, Chapter 18, which would do the following:

- **Beginning January 1, 2018, and each tax year after 2018, levy and impose a flow-through entity tax equal to the individual income tax on every taxpayer with business activity in the State unless otherwise prohibited by Federal law.**
- **For tax years beginning on and after January 1, 2018, allow a flow-through entity to elect to file a return and pay the flow-through entity tax.**
- **Specify that the flow-through entity tax would be imposed on the business income tax base, subject to certain adjustments.**
- **State that the tax base established under the bill would have to be apportioned in accordance with allocation and apportionment provisions in Chapter 3 of the Act.**
- **List the circumstances under which a taxpayer would be subject to tax in another state.**
- **Allow any taxpayer allocated income as a member of a flow-through entity by the flow-through entity to claim a credit against the flow-through entity tax in an amount equal to the taxpayer's allocated share of the tax as reported by the other flow-through entity.**
- **Allow a taxpayer a credit against the flow-through entity tax for the amount of an income tax imposed on the taxpayer for the tax year by another state, the District of Columbia, or a Canadian province, on income derived from certain sources outside of Michigan.**
- **Beginning with the 2019 tax year, require a taxpayer that reasonably expected liability for the tax year to exceed \$800 to file an estimated return and pay an estimated tax for each quarter of the tax year.**
- **Require a flow-through entity that elected to pay the flow-through entity tax to either file an annual or final return or file an irrevocable election to pay the tax beginning January 1, 2018.**
- **Allow the Department of Treasury to extend the date for filing the annual return upon application of the taxpayer and for good cause shown.**
- **Require a taxpayer or a flow-through entity that did not make the election to file a return to provide certain information to any member to which the provision of information would be required by the Internal Revenue Code.**
- **Require certain estates and trusts to report to its beneficiaries their allocable share of the flow-through entity tax.**
- **Allow a unitary business group to elect to file a combined return.**
- **Require the Department to administer the flow-through entity tax and allow it to promulgate rules for the maintenance of certain information.**
- **Require the Department to prepare and publish statistics from the records kept to administer the flow-through entity tax.**

- **Specify that the revenue collected under the bill would have to be distributed to the General Fund.**
- **Specify that a person that was a disregarded entity for Federal income tax purposes under the Internal Revenue Code would have to be classified as a disregarded entity for the purposes of the bill.**

In addition, the bill would allow a taxpayer who was either a member of a flow-through entity or an indirect member of a flow-through entity that elected to file under the bill to claim a credit against the individual income tax or Corporate Income Tax.

"Flow-through entity" would mean an entity that for the applicable tax year is treated as an S corporation or a partnership under the Internal Revenue Code for Federal income tax purposes. Flow-through entity would not include a publicly traded partnership or any person that was a disregarded entity for Federal income tax purposes under the Code.

The bill would be retroactive and effective for tax years beginning on and after January 1, 2018.

Substantial Nexus

Except as otherwise provided in the bill, a taxpayer would have substantial nexus in the State and would be subject to the flow-through entity tax if the taxpayer elected to pay the tax and if the taxpayer had a physical presence in Michigan for a period of more than one day during the tax year, actively solicited sales in the State and had gross receipts sourced to the State, or was a member or had an ownership interest or a beneficial interest in a flow-through entity, directly, or indirectly through one or more other flow-through entities, that had substantial nexus in the State.

Flow-Through Entity Tax

Beginning January 1, 2018, and each tax year thereafter, the bill would levy and impose a flow-through entity tax on every taxpayer with business activity in the State unless prohibited by 15 USC 381 to 384. (Under, 15 USC 381 to 384, no state or political subdivision of a state may impose a net income tax on the income derived within the state by any person from interstate commerce if certain conditions apply.) The flow-through entity tax would be imposed on the business income tax base, after allocation or apportionment to the State, at the same rate levied and imposed under Section 51 for that same tax year.

(Section 51 of the Income Tax Act levies a tax of 4.25% after October 1, 2012, upon the taxable income of every person other than a corporation. The tax applies to the reception, earning, or otherwise acquisition of income from any source whatsoever.)

The business income tax base means a taxpayer's business income subject to the following adjustments, before allocation or apportionment, and the other adjustment described below after allocation or apportionment:

- Add interest income and dividends derived from obligations or securities of states other than Michigan, in the same amount that was excluded from Federal taxable income, less the related portion of expenses not deducted in computing Federal taxable income as listed in the Internal Revenue Code.
- Add all taxes on or measured by net income including the flow-through entity tax to the extent that the taxes were deducted in arriving at Federal taxable income.

- To the extent included in Federal taxable income, deduct dividends and royalties received from people other than United States persons and foreign operating entities, including certain amounts under the Code.
- To the extent deducted in arriving at Federal taxable income, add any royalty, interest, or other expense paid to a person related to the taxpayer by ownership or control for the use of an intangible asset if the person were not included in the taxpayer's unitary business group.
- To the extent included in Federal taxable income, deduct interest income derived from United States obligations.
- Eliminate income from producing oil and gas to the extent included in and arriving at Federal taxable income, and income derived from a mineral to the extent included in Federal taxable income and expenses of producing oil and gas, and those related to the mineral income to the extent deducted in arriving at Federal taxable income.

For the purposes of the deductions described above, the business income of a unitary business group would be the sum of the business income of each person included in the group less any items of income and related deductions arising from transactions including dividends between people included in the group.

The bill would require the deduction of any available business loss incurred on or after a tax year for which an election was made under the bill. "Business loss" would mean a negative business income taxable amount after allocation or apportionment as reported on a return filed under an election made under the bill.

Apportionment

Except as otherwise provided, the tax base established under Part 4 would have to be apportioned in accordance with allocation and apportionment provisions in Chapter 3 of the Income Tax Act. For a taxpayer that had a direct, or indirect through one or more other flow-through entities, ownership interest or beneficial interest in a flow-through entity, the taxpayer's business income that was directly attributable to the business activity of the flow-through entity would have to be apportioned to the State using an apportionment factor determined under Chapter 3 based on the business activity of the flow-through entity unless the entity was included with a unitary business group filing a combined return.

A taxpayer would be subject to tax in another state in either of the following circumstances:

- The taxpayer was subject to, or would be subject to, if the taxpayer were not a flow-through entity, a business privilege tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax.
- That state had jurisdiction to subject the taxpayer to one or more of the taxes listed above, regardless of whether, in fact, that state subjected the taxpayer to that tax.

Filing Election

For tax years beginning on and after January 1, 2018, a flow-through entity could, in a form and manner prescribed by the Department of Treasury, elect to file a return and pay the flow-through entity tax in any tax year. An election for a tax year would not obligate the flow-through entity to make the same election in subsequent tax years. A separate election would have to be made for each tax year in a timely manner.

Quarterly Returns & Payments

Except as otherwise provided, beginning with the 2019 tax year, a taxpayer that reasonably

expected liability for the tax year to exceed \$800 would have to file an estimated return and pay an estimated tax for each quarter of the taxpayer's tax year. For taxpayers on a calendar year basis, the quarterly returns and estimated payments would have to be made by April 15, July 15, October 15, and January 15. Taxpayers that were not on a calendar year basis would have to file quarterly returns and make estimated payments on the appropriate due date which in the taxpayer's fiscal year corresponded to the calendar year.

Except as otherwise provided, the estimated payment made with each quarterly return of each tax year would have to be for the estimated tax base that was applicable to the taxpayer under the bill for the quarter or 25% of the estimated annual liability. The second, third, and fourth estimated payments in each tax year would have include adjustments, if necessary, to correct underpayments or overpayments from previous quarterly payments in the tax year to a revised estimate of the annual tax liability. For a taxpayer that calculated and paid estimated payments for certain Federal income tax purposes, that taxpayer could use the same methodology as used to calculate the annualized income installment or the adjusted seasonal installment, whichever was used as the basis for the Federal estimated payment, to calculate the estimated payments required each quarter.

The interest and penalty provided under Part 4 could not be assessed if any of the following occurred:

- If the sum of the estimated payments equaled at least 85% of the liability and the amount of each estimated payment reasonably approximated the tax liability incurred during the quarter for which the estimated payment was made.
- For the 2019 tax year and each subsequent tax year, if the preceding year's tax liability under the bill was \$20,000 or less and if the taxpayer submitted four equal installments, the sum of which equaled the immediately preceding tax year's tax liability.

Each estimated return would have to be made on a form prescribed by the Department and would have to include an estimate of the annual tax liability and other information required by the State Treasurer. The form could be combined with any other tax reporting form prescribed by the Department.

With respect to a taxpayer filing an estimated tax return for the taxpayer's first tax year of less than 12 months, the amounts paid with each return would have to be proportional to the number of payments made in the first tax year. A taxpayer with a tax year of less than four months would not have to file an estimated tax return or remit estimated payments.

Payments made under these provisions would have to be a credit against the payment required with the annual tax return required under the bill. If the Department considered it necessary to insure payment of the tax or to provide a more efficient administration of the tax, the Department could require filing of the returns and payment of the tax for other than quarterly or annual periods.

For the first tax year beginning on or after January 1, 2018, a flow-through entity that elected to pay the flow-through entity tax would have to, on or before the last day of the third month after the end of the tax year, either file an annual or final return as requested or file an irrevocable election to pay the tax for that tax year in the form and manner prescribed by the Department. For any subsequent tax year, a flow-through entity that elected to pay the tax would have to, on or before the fifteenth day of the fourth month of that tax year, file an irrevocable election, in the form and manner prescribed by the Department, to pay the tax for that tax year.

An annual or final return for the flow-through entity tax would have to be filed with the Department by the last day of the third month after the end of the taxpayer's tax year. Any

final liability would have to be remitted by the annual due date of the taxpayer's annual or final return, excluding any extension of time to file the return as provided below. A taxpayer whose tax liability under the bill was less than or equal to \$100 would not need to file a return or pay the flow-through entity tax. The Department could provide rules for filing an information only return for tax years for which an election was not made after a tax year for which a return was filed under Part 4.

Credit Claims

Any taxpayer allocated income as a member of a flow-through entity by the flow-through entity could claim a credit against the flow-through entity tax in an amount equal to the taxpayer's allocated share of the tax as reported by the other flow-through entity as described under the bill.

A taxpayer would be allowed a credit against the flow-through entity tax due for the amount of an income tax imposed on the taxpayer for the tax year by another state of the United States, a political subdivision of another state, the District of Columbia, or a Canadian province, on income derived from sources outside Michigan that also was subject to the flow-through entity tax or the amount determined under these provisions, whichever was less. For purposes of the Canadian provincial credit, the credit would be allowed only for that portion of the provincial tax not claimed as a credit for Federal income tax purposes. It would be presumed that the Canadian Federal income tax would be claimed first. The provincial tax claimed as a carryover deduction as provided in the Internal Revenue Code would not be allowed as a credit. The credit under the bill could not exceed an amount determined by dividing income that was subject to taxation both in the State and in another jurisdiction by taxable income and then multiplying that result by the taxpayer's tax liability before any credits were deducted.

Except as otherwise provided, for tax years beginning on and after January 1, 2018, a taxpayer who was either a member of a flow-through entity that elected to file a return and pay the flow-through entity tax or a direct or indirect member of another flow-through entity that elected to file a return and pay the tax could claim a credit against the tax imposed under Part 1 of the Income Tax Act (the individual income tax) or the tax imposed under Part 2 of the Act (the Corporate Income Tax) in an amount equal to the member's allocated share of the tax as reported to the member by the flow-through entity under the bill for the tax year ending on or within the taxpayer's same tax year.

For a taxpayer that was an estate or trust, the amount of the credit allowed would have to be determined by multiplying the amount calculated above by a percentage equal to a fraction, the numerator of which would be the flow-through entity business income tax base that was retained by the estate or trust and the denominator of which would be the total flow-through entity business income tax base that was included in distributable net income.

For a taxpayer who was a beneficiary of an estate or trust that was either a member of a flow-through entity that elected to file a return and pay the flow-through entity tax or a direct or indirect member of another flow-through entity that elected to file a return and pay the tax, the amount of the credit allowed would be equal to the allocable share of the tax for the year ending on or within the taxpayer's same tax year as reported to the beneficiary in accordance with the bill.

If the credit allowed under these provisions exceeded the tax liability of the taxpayer for the tax year, that portion of the credit that exceeded the tax liability would have to be refunded.

Filing Date Extension

The Department, upon application of the taxpayer and for good cause shown, could extend

the date for filing the annual return. Interest at the rate under the revenue Act would have to be added to the amount of the tax unpaid for the period of the extension. The State Treasurer would have to require with the application payment of the estimated tax liability unpaid for the tax period covered by the extension.

If a taxpayer were granted an extension of time within which to file the Federal income tax return for any tax year, the filing of a copy of the request for extension together with a tentative return and payment of an estimated tax with the Department by the due date stated above would extend automatically the due date for the filing of an annual or final return under the bill until the last day of the eighth month following the original due date of the return. Interest at the rate found under the revenue Act would have to be added to the amount of the tax unpaid for the period of the extension.

Additional Filing Requirements

A taxpayer required to file a return could be required to furnish a true and correct copy of any return or portion of any return filed under the provisions of the Internal Revenue Code. A taxpayer would have to file an amended return with the Department showing any alteration in or modification of a Federal income tax return that affected its tax base under Part 4. The amended return would have to be filed within 120 days after the final determination by the Internal Revenue Service.

At the request of the Department, a taxpayer required by the Internal Revenue Code to file or submit an information only return of income paid to others would have to, to the extent the information was applicable to residents of Michigan, at the same time file or submit the information in the form and content prescribed to the Department.

Flow-Through Entities; Nonparticipants

A taxpayer or a flow-through entity that did not make the election under the bill would have to provide on or before the due date of the return, upon the amendment of a filed return or the adjustment of the flow-through entity tax by the Department, to any member to which the provision of information was required by the Internal Revenue Code all of the following for the tax year:

- Information regarding the allocation and apportionment of the business income described under Part 4.
- The amount of flow-through entity tax that was deducted or included in the determination of the member's share of business income.
- If the reporting flow-through entity were a taxpayer, the member's share of the flow-through entity tax on the taxpayer for the tax year.
- If the reporting flow-through entity did not make the election under the bill, the member's share of the amount of tax allocated to the reporting flow-through entity under this provision and the previous provision regarding the member's share of the flow-through entity tax by the other flow-through entities with tax years ending on or within the reporting entity's tax year.
- The member's share of the tax allocated under the previous two provisions would have to be determined based on the member's share of the income or gain generating the flow-through entity tax and included in the member's share of business income.

If a member were allocated different portions of separately reported categories of income and gain, then the allocated share of tax would have to be based on the flow-through entity tax on each separate category of income or gain.

Estates or Trusts

An estate or trust who was either a member of a flow-through entity that elected to file a return and pay the flow-through entity tax or a direct or indirect member of another flow-through entity that elected to file a return and tax would have to on or before the due date of the return required under Part 1 of the Act report to its beneficiaries their allocable share of the flow-through entity tax and incurred by the estate or trust in that same tax year. The allocable share would be determined by multiplying the total amount of flow-through entity tax and incurred by the estate or trust in the tax year by a percentage equal to a fraction, the numerator of which would be the flow-through entity business income tax base that was distributed to the beneficiaries and the denominator of which was the total flow-through entity business income tax base that was included in distributable net income.

Unitary Business Groups & Affiliated Groups

A unitary business group could elect to file a combined return that included each United States person that was included in the group. Each United States person included in a unitary business group or included in a combined return would have to be treated as a single person, and all transactions between those people included in the group would have to be eliminated from the flow-through entity business income tax base and from the apportionment formula.

A person that was part of an affiliated group could elect without the consent of the Department to have all of the people that were included in that group to be treated as a unitary business group. A taxpayer that elected to file as a unitary business group under these provisions would have to compute its flow-through entity tax in accordance with all other provisions of the bill that applied to a unitary business group. The taxpayer would have to make the election on a form or in a format as prescribed by the Department that would have to be filed in a timely manner with the taxpayer's annual return.

Each person included in the affiliated group would be deemed to have agreed to be bound by the election and any renewal of that election and to have waived any objection to its inclusion in the affiliated group and treatment as a unitary business group. Each person that subsequently entered the affiliated group after the tax year for which the election was made would be deemed to have consented to the application of and would be bound by the election and to have waived any objection to its inclusion in the affiliated group and treatment as a unitary business group. An election made under these provisions would be irrevocable and binding for and applicable to the tax year for which it was made and for the next nine tax years but the liability for the flow-through entity tax would apply only for the years in which an election under the bill was made.

After the expiration of the election after it had been in effect for 10 tax years, an election could be renewed for another 10 tax years without the consent of the Department, provided however, that in the case of a nonrenewal a new election under these provisions would not be permitted in any of the immediately following three tax years. The renewal would have to be made on a form or in a format as prescribed by the Department that would have to be filed in a timely manner with the taxpayer's annual return after the completion of a 10-year period for which an election under these provisions was in place.

Flow-Through Entity Tax Administration

The flow-through entity tax would have to be administered by the Department under the revenue Act and the bill. If a conflict existed between the Act and the bill, the provisions of the bill would control. The Department could promulgate rules to implement Part 4 under the Administrative Procedures Act. The Department also would have to prescribe forms for use by taxpayers and could promulgate rules in conformity with the bill for the maintenance by

taxpayers of records, books, and accounts, and for the computation of the tax, the manner and time of changing or electing accounting methods and of exercising the various options contained in the bill, the making of returns, and the ascertainment, assessment, and collection of the flow-through entity tax. The tax would be in addition to all other taxes for which the taxpayer could be liable.

The Department would have to prepare and publish statistics from the records kept to administer the flow-through entity tax that detailed the distribution of tax receipts by type of business, legal form of organization, sources of tax base, timing of tax receipts, and types of deductions. The statistics could not result in the disclosure of information regarding any specific taxpayer.

Revenue Distribution & Appropriation

The revenue collected under the bill would have to be distributed to the General Fund.

There also would be appropriated to the Department for the State Fiscal Year (FY) 2018-2019 the sum of \$100 to begin implementing the requirements of the bill. Any portion of this amount that was not spent in FY 2018-19 would not lapse to the General Fund but would be carried forward in a work project account that complied with the Management and Budget Act.

Proposed MCL 206.254 et al.

Legislative Analyst: Drew Krogulecki

FISCAL IMPACT

While the bill would not affect total State revenue, the bill would reduce individual income tax revenue to the School Aid Fund, and increase General Fund revenue, by approximately \$180.0 million per year, based on data from tax year 2016. However, to the extent that some taxpayers did not elect to file under the bill's provisions, the shift in revenue between the two Funds would be less. It is unknown how many taxpayers would elect to file under the bill's provisions. Furthermore, because business income tends to swing significantly from year to year, and can change substantially in reaction to changes in the economy, the impact of the bill could vary significantly from year to year.

Under the bill, a portion of the liability that is currently paid under the individual income tax effectively would be paid under a new tax created in a new Part 4 of the Income Tax Act. The new tax would be credited to the General Fund, while currently 23.8% of individual income tax revenue is distributed to the School Aid Fund.

The impact assumes that taxpayers would no longer make income tax withholding, or quarterly or annual payments, under the individual income tax for income covered by the bill's provisions. To the extent that taxpayers did make such payments, the reduction in School Aid Fund revenue would be less (and the gain in General Fund revenue would be less) than estimated because the School Aid Fund earmark is applied against gross collections (thus excluding any refunds).

Fiscal Analyst: David Zin

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