

CREATE FLOW-THROUGH ENTITY TAX

Phone: (517) 373-8080
<http://www.house.mi.gov/hfa>

House Bill 4288 as enrolled
Sponsor: Rep. Mark Tisdell
House Committee: Tax Policy
Senate Committee: Finance
Complete to 10-9-21

Analysis available at
<http://www.legislature.mi.gov>

(Vetoed by the Governor 7-13-21)

SUMMARY:

House Bill 4288 would amend the Income Tax Act by adding a new Part 4, and making related changes, to do all of the following:

- For tax years beginning on and after January 1, 2021, levy a flow-through entity tax equal to the individual income tax rate on every flow-through entity that elected to pay the new flow-through entity tax, unless otherwise prohibited by federal law. (If the tax credit exceeded the taxpayer's liability, the difference would be refunded.) The same would apply to a nonresident estate or trust, except that the credit would be adjusted to account for the current state income tax rate. [Secs. 254, 675, and 759]
- Prescribe how a flow-through entity electing to pay the new tax must file its election with the Department of Treasury and stipulate that the election would be irrevocable for the next two tax years. [Sec. 791]
- Specify that the flow-through entity tax would be imposed on the positive business income allocated or apportioned to Michigan subject to certain adjustments made prior to allocation or apportionment to Michigan. [Sec. 759]
- Require that the tax base established be apportioned in accordance with the allocation and apportionment provisions in Chapter 3 of the act and specify when a taxpayer would be subject to tax in another state. [Sec. 761]
- Allow a taxpayer allocated income as a member of a flow-through entity to claim a credit against the flow-through entity tax in an amount equal to the taxpayer's allocated share of that tax as reported by the other flow-through entity. [Sec. 771]
- Require a taxpayer that reasonably expected its tax liability to exceed \$800 to file an estimated return and pay an estimated tax for each quarter of the tax year. [Sec. 781]
- Provide a deadline of three months after the taxpayer's tax year for filing of the annual or final return for the flow-through entity tax, unless the taxpayer was granted an extension by the Department of Treasury, upon application and for good cause shown. Interest at the rate under section 23(2) of the act would be added to the amount of the tax unpaid for the period of the extension. [Sec. 785]
- Allow the Department of Treasury to require copies of federal income tax returns and require amended returns to be filed with the department. [Sec. 787]
- Require a flow-through entity that did not make the election to pay the new tax to provide certain tax information to any member to which the information is required to be provided by the Internal Revenue Code. [Sec. 789]
- Require an estate or trust that is a member of a flow-through entity electing to pay the new tax to report to its beneficiaries their allocable share of the tax incurred by the estate or trust. [Sec. 789]

- Provide that the provisions of the bill would prevail if they were in conflict with 1941 PA 122, known as the revenue act. [Sec. 791]
- Allow the Department of Treasury to promulgate rules to implement the bill and require the department to administer the flow-through entity tax. The department also would have to prepare and publish statistics from the records kept to administer the tax that detail 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. [Sec. 791]
- Require that the percentage of gross collections of the flow-through entity tax, before refunds, that is equal to 1.012% divided by the tax rate levied under the new Part 4 be deposited in the School Aid Fund and that the balance of the revenue collected be deposited in the general fund. [Sec. 793]

The bill would authorize a taxpayer who was a member or indirect member of a flow-through entity that elected to file and pay the flow-through entity tax created under the bill to claim a credit against the Michigan individual income tax or Michigan 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. Any credit claimed would be refunded if it exceeded the taxpayer's tax liability. [Secs. 254 (Part 1: Individual Income Tax) and 675 (Part 2: Corporate Income Tax)]

The bill would be retroactive and effective for tax years beginning on and after January 1, 2021.

MCL 206.254 et seq.

BACKGROUND:

House Bill 4288 is a reintroduction of Senate Bill 1170 of the 2017-18 legislative session,¹ which was passed by both the House and Senate but vetoed by Governor Snyder. In his veto letter, the governor cited the substantial changes proposed in the bill and the short time frame in which it was considered.² Of note, that bill included an appropriation of \$5.0 million in FY 2018-19 to the Department of Treasury to begin implementation of the bill's requirements and created a work project account so that any unexpended funds could be carried forward and spent in the following fiscal year. HB 4288 does not include an appropriation.

BRIEF DISCUSSION:

The bill was broadly and enthusiastically supported by the business community as a way to provide relief to businesses struggling during the pandemic. They argued that it would save approximately 170,000 businesses a total of \$190.0 million per year without costing the state any tax revenue (because it would lower the amount paid by those businesses in federal taxes.)

According to committee testimony, the measure faced opposition in 2018 and was ultimately vetoed because there was uncertainty as to whether the IRS would allow it. Given that it is essentially a workaround to let partnerships, S-corporations, and some LLCs that itemize deduct state and local taxes (SALT) beyond the \$10,000 cap, some wondered if it made sense to make the change only to see it rendered moot by the IRS. However, since that time at least

¹ <http://www.legislature.mi.gov/documents/2017-2018/billanalysis/House/pdf/2017-HLA-1170-52E6BF89.pdf>

² https://content.govdelivery.com/attachments/MIGOV/2018/12/28/file_attachments/1130290/Veto%20Letter%201170.pdf

a dozen states have approved the workaround, and the IRS issued guidance in November 2020, effectively allowing it in certain cases.³

In response, the Department of Treasury argued that implementation of a new system to accommodate the new rules would cost approximately \$5.0 million. The SALT cap is scheduled to expire in 2025, and they argued that it would not make sense to overhaul the system to benefit a few high-earning Michiganders for only a few years.

FISCAL IMPACT:

The purpose of the bill is to allow the tax liability from flow-through income in Michigan to be paid in such a manner that the tax is deductible at the federal level on the corporation tax return (which does not cap deductions for state and local taxes), as opposed to a recipient's individual income tax return (on which the equivalent deduction has been capped at \$10,000 by the Tax Cuts and Jobs Act).

With respect to the Michigan individual income tax, because the revenue from the tax on flow-through entities in Part 4 would be distributed in the same way as revenue collected under the individual income tax in Part 1, there would be no impact on either total revenue or the amounts accruing to the School Aid Fund and the general fund.

According to the Department of Treasury, the one-time costs associated with creating a new information technology system to implement the tax changes under the bill would be \$8.0 to \$10.0 million.

Vetoed 7-13-21:

In her veto message, Governor Whitmer stated that the bill would require the Department of Treasury to spend approximately \$5.0 million to implement new IT systems “to administer a tax break that would primarily benefit a small number of Michiganders.” Further, she encouraged the legislature to work on a comprehensive budget instead of a “tax sweetener,” as she described House Bill 4288.

Legislative Analyst: Jenny McInerney
Fiscal Analyst: Jim Stansell

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

³ <https://www.irs.gov/pub/irs-drop/n-20-75.pdf>