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BILL ANALYSIS

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House Bill 5367 (Substitute H-1 as reported without amendment)
Sponsor: Representative Mark Tisdel
House Committee: Second Reading
Senate Committee: Finance

CONTENT

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

-- Define various terms, including "flow-through entity" and "business income", for the purposes of Part 4.
-- Define substantial nexus for the purposes of the flow-through entity tax.
-- Beginning January 1, 2021, and each tax year after that, 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, 2021, 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 positive business income tax base, subject to certain allocations adjustments.
-- State that the tax base would have to be apportioned in accordance with allocation and apportionment provisions in Chapter 3 of the Act.
-- Prohibit a taxpayer allocated income as a member of a flow-through entity by the entity from claiming a credit against the flow-through entity tax for the taxpayer's allocated share of the tax as reported by the other entity.
-- Require a taxpayer that reasonably expected liability for the tax year to exceed $800 to file an estimated return and pay a quarterly estimated tax.
-- Require a flow-through entity that elected to pay the flow-through entity tax to either file an annual or final return by the last day of the third month after the end of the taxpayer's tax year.
-- 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 (IRC).
-- Require certain estates and trusts to report to its beneficiaries their allocable share of the flow-through entity tax.
-- Require the Department to administer the flow-through entity tax and allow it to promulgate rules for the maintenance of certain information.
-- Specify that the revenue collected under the bill would have to be distributed to the State School Aid Fund and the General Fund.
-- Specify that a person that was a disregarded entity for Federal income tax purposes under the IRC would have to be classified as a disregarded entity for the purposes of the bill.

In addition, the bill would amend the Act to allow, for tax years beginning on and after January 1, 2021, a member of a flow-through entity or an indirect member of a flow-through entity

that elected to pay the proposed flow-through entity tax to claim a credit against the individual income tax or Corporate Income Tax.

The bill also would amend the Act to allow, for the 2016, 2017, 2018, and 2019 tax years, and for every tax year from 2025 onward, a disabled veteran to deduct income attributable to the cancellation or discharge of a student loan under the Total and Permanent Disability Discharge Program.

The bill states that the new flow-through entity tax would be retroactive and is intended to apply retroactively for tax years beginning on and after January 1, 2021. The tax deduction for disabled veterans also would be retroactive, applying to the 2016, 2017, 2018, and 2019 tax years.

MCL 206.30 et al. Legislative Analyst: Christian Schmidt

FISCAL IMPACT

The bill would alter current tax law primarily through two changes. The first change would create a special pass-through entity tax and allow a credit under the individual income tax for taxes paid under the new pass-through entity tax. The second change would provide a deduction for income associated with a discharge of student loan debt received by a disabled veteran.

The first change, with respect to the pass-through entity tax, would have no impact on State revenue. Members of pass-through entities currently are taxed under the individual income tax; the proposed tax would be levied at the same rate and distributed in the same manner as the individual income tax. The primary difference from current law is that the tax would be paid at the business-entity level rather than the level of individual members of the business entity. As a result, individual members would not be affected by the Federal limitation on the deduction (currently $10,000) of State and local individual income taxes and could receive a greater deduction on their Federal taxes.

The second change, with respect to the discharge of student loan debt held by disabled veterans, would reduce State individual income tax revenue. The retroactive provisions of the bill would reduce revenue by approximately $600,000 in fiscal year (FY) 2021-22, and then the bill would not have a fiscal impact until FY 2026-27, when it would reduce revenue by approximately $2.7 million per year. How the reduction would affect General Fund and School Aid Fund revenue is discussed below.

According to statistics from the US Veterans Administration, in 2018 there were approximately 18,000 individuals in Michigan who were rated as 100% disabled, one of several qualifications under the bill. It is unknown how many of them have student loan debt, the value of their debt, or how many would seek a discharge under Federal programs. Over a five-year period from 2014-2018, there were 715,800 borrowers nationally who received discharges under the Total and Permanent Disability Discharge Program for $17.8 billion of principal and $1.8 billion of interest. Statewide data are not available, of which a subset of those were veterans. Disabled veterans living in Michigan represent approximately 2.3% of the total nationally. Based on the total number of loan discharges known to originate with disability determinations from the Veterans Administration over the 2015-2018 period, and assuming Michigan's disabled veteran population exhibits the same average student loan debt characteristics as the average borrower who received a discharge nationally, the retroactive provisions of the bill would reduce individual income tax revenue by approximately $600,000 in FY 2020-21. Because revenue impact from the retroactive provisions would be in the form of refund requests filed with amended returns, all of the impact would reduce General Fund revenue.

Currently, Federal law exempts student loan discharges issued between January 1, 2018, and December 31, 2025, from Federal AGI. As a result, no discharges that occur during that time period have been, or will be, included in the Michigan tax base.

While the bill would allow an eligible taxpayer to deduct discharged amounts included in Federal AGI for tax years that begin on or after January 1, 2025, because of the Federal provisions, the bill would have no impact until January 1, 2026.

Beginning tax year 2026, the bill would reduce revenue by an amount that would depend on how student borrowing and tuition change, and how rates of loan discharge under the Total and Permanent Disability Discharge Program could change. However, assuming current individual income tax rates, growing the 2014-2018 average loan discharge amount at 5.0% per year for eight years (from 2018 to 2026), and adjusting for the 12.1% average annual increase in the veteran population at 100% disability over the 2015-2019 period, would increase the revenue reduction to approximately $2.7 million per year beginning with tax year 2026.

Beginning in tax year 2026, any revenue reduction under the bill could affect either gross collections from withholding, estimated, and annual payments and/or individual income tax refunds. Any increase in refunds would affect only General Fund revenue. However, 23.8% of any reduction in gross collections would lower School Aid Fund revenue, with any remaining reduction lowering General Fund revenue.

Date Completed: 11-1-21 Fiscal Analyst: David Zin

This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.