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BILL ANALYSIS

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House Bill 4361 (as enacted) **PUBLIC ACT 38 of 2011**
House Bill 4362 (as enacted) **PUBLIC ACT 39 of 2011**
House Bill 4479 (as enacted) **PUBLIC ACT 40 of 2011**
Sponsor: Representative Jud Gilbert, II
House Committee: Tax Policy
Senate Committee: Reforms, Restructuring, and Reinventing

Date Completed: 5-26-11

CONTENT

House Bill 4361 amends the Income Tax Act, eliminating numerous credits, deductions and exemptions, as well as changing future tax rates. House Bill 4361 also creates a new Corporate Income Tax, which will be levied on businesses organized as traditional corporations under Federal law.

House Bill 4362 amends the Michigan Business Tax (MBT) Act to allow certain taxpayers that wish to claim select credits allowed under the law to continue claiming those credits if they continue to file returns under the MBT Act.

House Bill 4479 amends the Multistate Tax Compact to remove the option for certain out-of-state taxpayers to apportion their tax base (under either the MBT or the new Corporate Income Tax) using an equally weighted three-factor formula instead of the 100%-sales factor formula specified in the MBT and the Corporate Income Tax.

House Bill 4361 will take effect on January 1, 2012, except the amendments to the individual income rate will take effect on October 1, 2011. House Bills 4362 and 4479 took effect on May 25, 2011.

Individual Income Tax Provisions

House Bill 4361 makes substantial revisions to the income tax levied on individuals. The definition of taxable income will be altered in the following ways:

- Retirement or pension benefits under the Federal Railroad Retirement Act of 1974 will not be taxable.
- Political contributions will no longer be deductible.
- Wages included in Federal adjusted gross income (AGI) not deductible under Section 280C of the Internal Revenue Code will no longer be deductible.
- Senior citizens born after 1945 will no longer be able to deduct a portion of interest, dividends, and capital gains received.
- Taxpayers will no longer receive an additional $600 exemption per dependent child under the age of 19.
- Distributions from certain individual retirement accounts used to pay qualified higher education expenses will no longer be deductible.
- Charitable contributions made from a qualified retirement plan or account will no longer be deductible.
- Reinvestments of gains made from certain investments certified by the Michigan Strategic Fund will no longer be deductible.
- If deducted in determining Federal AGI, expenses incurred in producing oil and gas will no longer be deducted from AGI a second time. To the extent included in Federal AGI, income received from producing oil and gas will be excluded from income.

In addition, the deduction allowed for pension and retirement income, including social security, will be modified. Rather than applying the modifications to each individual with income on the return, the bill bases the modifications on the age of the older spouse when the return is filed, as described below:

a) For taxpayers born before 1946, there will be no change in the treatment of retirement or pension income. Public pensions, as well as social security benefits and several other categories of income (including social security income), will be completely exempt from taxation. A portion of pension and retirement income from private plans will continue to be exempt from tax ($45,120 for single filers or $90,240 for joint filers in tax year 2010, and adjusted for inflation), although the private pension exemption will continue to be reduced by the amount of any compensation and retirement benefits received for services in the armed forces as well as any public pension. However, the bill also reduces the private exemption by the amount of any retirement or pension benefits received under the Federal Railroad Retirement Act of 1974.

b) For taxpayers born during the 1946 to 1952 period, the bill eliminates the current exemptions for retirement and pension income, although the exemptions for social security income and several other types of income exempt under current law will be retained while the taxpayer is less than 67 years of age. Until the taxpayer reaches age 67, the bill allows a new exemption that will exempt a portion of pension and retirement income ($20,000 for a single return or $40,000 for a joint return), regardless of whether the income is from a public or private pension. After the taxpayer reaches age 67, the bill keeps the exemption amount the same, but applies the exemption to all income, including retirement and nonretirement income. However, the bill retains the full exemption for social security income and select other types of income excluded under current law. Regardless of age, the bill eliminates the $20,000/$40,000 exemption if total household resources exceed $75,000 for a single return, or $150,000 for a joint return, or if a taxpayer claims the deduction for a military pension or railroad pension. The bill still allows a taxpayer to receive the standard personal exemption, regardless of age.

c) For taxpayers born after 1952, the bill eliminates any exemption of public or private pension or retirement income other than social security income and certain other types of income until the taxpayer reaches 67 years of age. Once the taxpayer reaches age 67, the bill replaces the standard personal exemption and allows an exemption ($20,000 for a single return or $40,000 for a joint return) against all types of income, including social security income and other types of income (including retirement and nonretirement income). The bill allows a taxpayer to forgo the $20,000/$40,000 exemption and instead deduct 100% of social security income and continue to claim the standard personal exemption. If a taxpayer elects to claim the $20,000/$40,000 exemption, he or she will not be allowed to claim either the deduction for social security income or the standard personal exemption. Regardless of age, the bill eliminates the $20,000/$40,000 exemption if total household resources exceed $75,000 for a single return, or $150,000 for a joint return, or if a taxpayer claims the deduction for a military pension or railroad pension.

House Bill 4361 also eliminates or changes several exemptions that presently may be claimed against income:

- The standard personal exemption for taxpayers and each dependent will be fixed at $3,700 (the level under current law) through tax year 2012. Beginning in 2013, the exemption again will be adjusted annually for inflation occurring after 2012.
- The standard personal exemption will be phased-out for single taxpayers with household resources between $75,000 and $100,000, and for married couples filing joint returns with household resources between $150,000 and $200,000.
- The additional $1,800 exemption allowed for each taxpayer age 65 and older, and each dependent of the taxpayer, will be eliminated.
- The additional $1,800 exemption received by taxpayers whose

unemployment compensation exceeds 50% of their AGI will be eliminated.

House Bill 4361 makes additional miscellaneous changes, including:

- Beginning January 1, 2011, business income reported under the individual income tax will be apportioned based on 100% of a sales factor, rather than the equally weighted, three-factor formula based on property, payroll, and sales under current law.
- Media production companies will be required to collect income tax withholding on amounts paid to performing artists or crew members, to the extent any necessary withholding is not made by a professional employer organization or professional services corporation.
- Entities disbursing pension or annuity payments will be required to collect withholding on those payments that are expected to be included in gross income.
- Flow-through entities, such as S-corporations, partnerships, and limited liability companies taxed as S-corporations or partnerships, will be required to collect withholding on the distributive shares of members' business income.
- Household income, as primarily used in determining eligibility under the Homestead Property Tax Credit and Home Heating Credit, will be changed to "total household resources". The primary difference between the two concepts is that "total household resources" is intended to exclude any subtractions due to net business, rental, or royalty losses.

House Bill 4361 also eliminates most credits available under the individual income tax and make substantive changes to the remaining credits. Credits eliminated or changed under the bill include those described below:

- Nonresident estates and trusts will no longer receive a credit related to reciprocity agreements with other states.
- For rehabilitation plans certified after January 1, 2012, the Historic Preservation Credit will be eliminated.
- For agreements entered into after January 1, 2012, tax vouchers issued under provisions related to the Michigan Early Stage Venture Investment Act will no longer be applied toward tax liability.
- For tax years after 2011, the Michigan Earned Income Tax Credit will be reduced from 20% to 6% of the Federal Earned Income Tax Credit the taxpayer receives.
- Qualified investments made after December 31, 2011, in qualified businesses will no longer be eligible for a credit certificate from the Michigan Strategic Fund.
- All nonrefundable credits, including the following, will be eliminated:

  a. The City Income Tax Credit.
  b. The Public Contribution Credit, for contributions to public entities such as State universities, public libraries, and the State museum.
  c. The Community Foundation Credit, for contributions to qualified community foundations.
  d. The Homeless/Food Bank Credit, for contributions made to homeless shelters, food banks, and food kitchens.
  e. The College Tuition Credit, which provides a credit equal to 8% of tuition costs for residents attending a university or college that increased its tuition from the prior year by less than the rate of inflation.
  f. The Vehicle Donation Credit, which provides a credit for automobiles donated to qualified organizations.
  g. The credit for contributions to individual and/or family development accounts.

The bill also makes a variety of changes to the Homestead Property Tax Credit:

a) Taxpayers will no longer be eligible for the credit if the taxable value of their homestead exceeds $135,000. (For a new home, this limit equates to a sale value of $270,000.)

b) The credit will be phased out starting at total household resources of $41,000 and be eliminated once total household resources reach $50,000. Under current law, the phase-out does not begin until household income exceeds $73,650.

c) Under current law, the credit equals some percentage of the property taxes that exceed 3.5% of household income, regardless of income. The applicable percentage varies, with most taxpayers receiving 60%, while seniors and disabled individuals are able to receive 100%. The bill will eliminate the difference in rates between seniors and most taxpayers, setting the applicable percentage at 60%. However, for senior citizens with income of $21,000 or less, the bill makes the applicable percentage 100%, phasing it down in four percentage point increments every $1,000 of household resources until the applicable percentage declines to 60% at household resources of $30,000.

In addition, House Bill 4361 alters the individual income tax rate levied in future years. Under current law, the tax rate is scheduled to decline from 4.35% to 4.25% on October 1, 2011. The rate then is scheduled to drop another 0.1 percentage point each subsequent October 1, until October 1, 2015, when the rate is to decline 0.05 percentage point, to 3.9%. The bill postpones the first rate reduction until January 1, 2013, and eliminates any subsequent rate reductions. As a result, the bill keeps the tax rate at 4.35% through January 1, 2013, and then lowers it to 4.25%, where it will remain.

Corporate Income Tax Provisions

House Bill 4361 segments the existing individual income tax provisions as Part 1, and adds a Part 2 to the Income Tax Act, representing a new income tax levied on corporations. The corporate income tax provisions largely mirror the provisions of the income tax portion of the current Michigan Business Tax Act and will be effective beginning January 1, 2012. However, unlike the MBT, which is levied on all businesses regardless of how they are organized, the Corporate Income Tax (CIT) will be levied only on businesses organized as a traditional corporation (a C-corporation) under Federal tax rules. Sole proprietorships and pass-through entities, such as partnerships, S-corporations, and limited liability companies taxed as a partnership or S-corporation, will not be required to pay taxes or file returns under the corporate income tax.

The Corporate Income Tax will apportion business activity across states using only the ratio of Michigan sales to total sales, as is currently done under the MBT. The Corporate Income Tax also will retain the MBT's unitary filing requirements for corporations under common control. The tax rate on corporate income will be 6.0% (approximately equal to the rate under the MBT, inclusive of the surcharge) and firms will not be required to file a return if their liability is less than $100. As under the MBT, firms with apportioned gross receipts of less than $350,000 will not be required to file a return. However, the CIT does not contain the filing threshold credit that the MBT offers.

The CIT does not retain a few adjustments to taxable income under the MBT, including those described below:

- Certain income or losses attributable to another entity will not be included.
- Charitable contributions made to the Michigan Education Trust will no longer be deductible.
- Certain gains and/or income related to qualified affordable housing may no longer be deducted from business income.
- A deduction for certain deferred tax liabilities will no longer be allowed.

The Michigan Business Tax exempts certain types of income or taxpayers from the tax and the bill does not retain some of these exemptions. House Bill 4361 does not exempt:

- Nonprofit housing corporations.
- Income from the production of agricultural goods, and a variety of other activities related to farmers' cooperative corporations.
- Income from services of an attorney-in-fact to a reciprocal insurer.
- The portion of a tax base attributable to a multiple employer welfare arrangement that only provides dental benefits.

The Corporate Income Tax does not retain any of the tax credits offered under the MBT, with the exception of the alternate tax credit. Firms eligible for this credit must have gross receipts of $20.0 million or less and adjusted business income of $1.3 million or less. The credit also places limits on the total of compensation and directors' fees to individual shareholders and officers. If a taxpayer qualifies for the credit, the taxpayer will receive a credit for the difference between the CIT liability and 1.8% of adjusted business income.

The Corporate Income Tax includes a tax on insurance companies that is identical to the tax such businesses face under the MBT. Financial institutions also will face the same net capital tax imposed under the MBT, and the 0.29% tax rate approximately equals the rate paid under the MBT, inclusive of the surcharge. However, the CIT will no longer allow financial institutions a deduction for goodwill.

House Bill 4361 will require flow-through entities, such as S-corporations, partnerships, and limited liability companies taxed as corporations, with more than $200,000 of business income to collect withholding applicable to the corporate income tax provisions on the distributive shares of members' business income.

House Bill 4361 appropriates $1.0 million to the Department of Treasury to implement the provisions of the CIT. Revenue from the CIT will be directed to the General Fund.

House Bill 4362 amends the MBT Act to provide for its eventual repeal and for certain taxpayers to continue to claim select credits. House Bill 4361 contains complementary and duplicative provisions related to House Bill 4362 and the option for certain taxpayers to continue to file an MBT return if they seek to claim certain credits. House Bill 4362 adds a definition of "certificated credit", which primarily includes credits related to a variety of MBT provisions that award a credit as a result of a taxpayer's obtaining a voucher or credit certificate as a result of some agreement with the State, for those agreements entered into before January 1, 2012. For example, under the MBT taxpayers may enter into an agreement related to brownfield improvements and, once the improvements are made, the taxpayers are eligible to receive a credit over a period of years. MBT credits that are preserved under the definition of "certificated credit" include:

- The Early Stage Venture Capital Credit
- Brownfield Redevelopment Credits
- Michigan Economic Growth Authority credits, including:
    a. Credits for Photovoltaic Technology
    b. The Employment Credit
    c. The Anchor Company Payroll Credit
    d. The Federal Government Employment Credit
    e. The Anchor Company Taxable Value Credit
    f. The Polycrystalline Silicon Manufacturing Credit
    g. Credits for High-Power Energy Batteries
    h. The Hybrid Technology Research and Development Credit
- The Media Production Credit
- The Media Infrastructure Credit
- The Historic Preservation Credit
- The Renaissance Zone Credit
- The NASCAR Speedway Credit
- The Farmland Preservation Credit

House Bill 4362 eliminates the MBT for most taxpayers, effective January 1, 2012, by amending the definition of "taxpayer". Beginning January 1, 2012, taxpayer will include only a person or unitary business group with a certificated credit that wishes to claim the credit and either is not subject to the new CIT or elects to file under the MBT rather than the new CIT.

House Bill 4362 requires that taxpayers electing to claim certificated credits pay a tax based on the greater of their MBT liability or a modified version of the liability they would have if they filed under the CIT. For these taxpayers, if the tax calculation results in a negative amount, the bill provides for that amount to be refunded. House Bill 4362 will repeal the MBT Act once the Secretary of State receives a written notice from the Department of Treasury that all certificated credits have been exhausted.

Multistate Tax Compact Provisions

The Multistate Tax Compact (MTC) codifies certain provisions regarding the taxation of taxpayers with activity in multiple state jurisdictions. House Bill 4479 amends the MTC to change the way taxpayers are allowed to apportion their activity between states. Under the law, a multistate taxpayer can elect to file under the provisions of the MTC rather than the requirements of the laws of states in which it has business activity. One of these provisions involves how to allocate business activity across states. The MTC allows a taxpayer to compute an apportionment factor by computing three separate factors, adding them together and dividing by three. The three factors are based on payroll, property, and sales, with each factor calculated by taking the amount of that factor attributable to the taxpayer within a state and dividing it by the total of that factor attributable to the taxpayer in all states. By dividing by three, the formula equally weights each of the factors. The MBT and the CIT use only a sales factor, taking Michigan sales and dividing that amount by the taxpayer's total sales. For an out-of-state taxpayer, particularly one with little or no property in Michigan, the three-factor formula produces a much smaller apportionment factor.

Under House Bill 4479, any taxpayer subject to either the MBT or the CIT does not have the option of using the apportionment factor in the MTC. As a result, all taxpayers are required to use the 100%-sales factor apportionment. The changes apply to all tax years beginning January 1, 2011, or later.

MCL 206.2 et al (H.B. 4361)
208.1107 et al. (H.B. 4362)
205.581 (H.B. 4479)

FISCAL IMPACT

The bills will reduce revenue by approximately $535.2 million in fiscal year (FY) 2011-12 and $224.0 million in FY 2012-13. General Fund revenue will increase by approximately $154.7 million in FY 2011-12 and $438.0 million in FY 2012-13 while School Aid Fund (SAF) revenue will decline by approximately $689.9 million in FY 2011-12 and $662.1 million in FY 2012-13. As discussed below, these estimates omit the impact of several of the bills' provisions.

Table 1 displays the estimated impact of the bills' various provisions, based on information from the Michigan Department of Treasury. Certain provisions, such as the inclusion of corporations engaged in agricultural production, do not appear to be incorporated into the estimates. Additionally, while House Bill 4361 specifies that the change in the apportionment formula for business income under the individual income tax will be effective January 1, 2011, the enabling section of the bill indicates that none of the changes, other than changes in Section 51 regarding the individual income tax rate, will be effective until January 1, 2012. As a result, any impact from changing the apportionment of business income under the individual income tax is not likely to have any fiscal impact during FY 2010-11.

Also, while the CIT retains the MBT's unitary filing requirements for businesses under common control, House Bill 4361 is unclear about how members of a unitary group that are not C corporations will be treated. Absent a unitary filing requirement, such entities will be exempt from the tax. If the provisions of the bill are interpreted to exempt non-C corporation entities from unitary groups, the bill likely will create a substantial incentive to reorganize business activity in order to evade taxation. It is unknown what treatment these unitary groups are assumed to receive under the estimates for the CIT or how their behavior might change under the bills.

House Bill 4361 does not eliminate any MBT provisions other than a reference under the Media Production Credit to a provision eliminated by the bill under the individual income tax sections. As a result, entities such as the Michigan Economic Growth Authority, the Michigan Film Office, and the Michigan Strategic Fund could continue to issue credits under those provisions. While any new credits will not be counted as certificated credits, they could be issued nonetheless. Similarly, the certificated credits duplicate credit amounts allowed under other sections. The language in House Bill 4362 allows a taxpayer, when computing its liability under the MBT, to claim amounts related to certificated credits under the original authorizing section and then again in new Section 500 as a certificated credit. Similarly, taxpayers will still be eligible to claim other credits not included in the certificated credit definition, such as the investment tax credit, the personal property tax credit, and the compensation credit. It is not clear to what extent the estimates presented in Table 1 reflect that taxpayers will be able to claim these credits in this fashion.

Several provisions in the bills will create unintuitive results. For example, the new exemption amount in House Bill 4361 for taxpayers born during the 1946-1952 period will remain the same amount when the taxpayers turn age 67 but will be applied to a broader income base. As a result, the value of the exemption actually will potentially increase once a taxpayer turns 67, because any unused value of the exemption can then be used to offset nonpension and nonretirement income. The additional personal exemption seniors receive under current law effectively accomplishes the same result, although the bill retains that exemption. Similarly, the bill retains withholding requirements on eligible production companies, but ties the definition to the definition under the Michigan Business Tax. To the extent the MBT Act is repealed, the effect on such companies is unclear. Also, House Bill 4362 effectively allows credits, such as the Media Production Credit, to continue to be awarded; unless a credit is awarded to a company with a certificated credit, however, the credit may not be used to reduce tax liability under the new CIT.

The bills will have no fiscal impact on local government.

Department of Treasury

The bills will increase the costs of the Michigan Department of Treasury, which administers and collects State taxes. House Bill 4361 includes a $1.0 million appropriation from General Fund/General Purpose (GF/GP) revenue for the costs of implementing the tax changes and the new Corporate Income Tax. The actual implementation costs of the bills will likely be significant, with current estimates in the range of $25.0 million, due to the need for alterations to computer systems, development of forms, instructions, and policy advice, and promulgation of administrative rules.

The bills will require the administration of two business tax systems for an unknown period of time. The Michigan Business Tax administration will continue for several years as companies file and amend returns and the Department conducts audits. In addition, the companies with certificated credits against the MBT will be permitted to elect to continue to pay taxes and receive those credits under the MBT. Depending on the number of companies that choose to continue taxation under the MBT and the length of the credits that they have been awarded, the administration of the MBT may continue for many years.

The legislation also includes extensive reporting requirements. The Department will be required to publish statistics on the distribution of tax receipts by several categories, consisting of type of business, legal organization, sources of tax base, timing of tax receipts, and types of deductions.

Michigan Strategic Fund

Under the bills, the Michigan Strategic Fund (MSF) is estimated to have a decrease in fee revenue. Currently, companies pay fees for Michigan Economic Growth Authority (MEGA) and Brownfield Credits. The MSF uses this fee revenue (which is not appropriated) in conjunction with appropriations in the Job Creation Services line item in the MSF budget to administer the programs. The fee revenue is typically approximately $1.0 million per year, although staff from the MSF have indicated that fee revenue in FY 2009-10 was nearly $2.0 million. Assuming that no agreements or credits are issued under the MBT as a result of the bills, the fee revenue will cease. Administrative costs, however, will continue for companies that choose to remain under the MBT in order to claim certificated credits. The ongoing costs will depend on the number of companies that continue to claim previously awarded credits. The bills do not make an appropriation for these costs.

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Table 1

Impact of House Bills 4361, 4362 and 4479, as Enacted (Millions of Dollars)						
	FY 2011-12 Estimates			FY 2012-13 Estimates		
	GF/GP	SAF	Total	GF/GP	SAF	Total
Business Tax Provisions						
Repeal MBT	($1,401.4)	($757.6)	($2,159.0)	($1,214.0)	($776.6)	($1,990.6)
Partial-year MBT Revenue	897.5	0.0	897.5	0.0	0.0	0.0
Corporate Income Tax	457.8	0.0	457.8	736.1	0.0	736.1
Financial Institutions Tax	27.7	0.0	27.7	43.9	0.0	43.9
Certificated Credits (net impact with filing option)	(268.3)	0.0	(268.3)	(462.0)	0.0	(462.0)
Multistate Tax Compact Changes	(50.0)	0.0	(50.0)	25.0	0.0	25.0
Subtotal Business Tax Changes	**($336.7)**	**($757.6)**	**($1,094.3)**	**($871.1)**	**($776.6)**	**($1,647.7)**
Individual Income Tax Provisions						
Delay Tax Rate Reduction until Jan. 1, 2013	$172.0	$0.0	$172.0	$223.0	$0.0	$223.0
Modify Public/Private Pension Exemption	177.4	47.5	224.9	259.6	83.7	343.3
Retain Military Pension Exemption	(4.1)	(1.0)	(5.1)	(5.9)	(1.9)	(7.8)
Phase-out Pension Exemption for High Incomes	4.1	1.0	5.1	5.9	1.9	7.8
Repeal Senior Interest/Dividend Exemption	3.2	0.8	4.1	4.7	1.5	6.3
Eliminate Senior/UI Comp Special Exemptions	6.7	2.1	8.8	40.8	0.0	40.8
Phase-out Personal Exemption	42.0	13.1	55.1	63.1	20.3	83.4
Eliminate Additional Child Exemption	0.0	0.0	0.0	57.1	0.0	57.1
Eliminate Other Miscellaneous Subtractions	28.1	7.2	35.4	40.8	13.2	54.0
Single Factor Apportionment of Business Income	(11.9)	(3.1)	(15.0)	(16.5)	(4.2)	(20.8)
Eliminate Nonrefundable Credits						
City Income Tax Credit	26.3	0.0	26.3	37.0	0.0	37.0
Public Contribution Credit	20.3	0.0	20.3	28.4	0.0	28.4
Community Foundations Credit	3.0	0.0	3.0	4.2	0.0	4.2
Homeless Shelter/Food Bank Credit	16.5	0.0	16.5	23.0	0.0	23.0
College Tuition Credit	7.1	0.0	7.1	9.9	0.0	9.9
Other Nonrefundable Credits	0.8	0.0	0.8	1.0	0.0	1.0
Eliminate Refundable Credits						
Adoption Credit	0.0	0.0	0.0	1.0	0.0	1.0
Stillbirth Credit	0.0	0.0	0.0	0.0	0.0	0.0
Reduce Earned Income Tax Credit	0.0	0.0	0.0	261.6	0.0	261.6
Modify Homestead Property Tax Credit	0.0	0.0	0.0	270.2	0.0	270.2
Subtotal Individual Income Tax Changes	**$491.4**	**$67.7**	**$559.1**	**$1,309.1**	**$114.5**	**$1,423.7**
Total Tax Changes	**$154.7**	**($689.9)**	**($535.2)**	**$438.0**	**($662.1)**	**($224.0)**

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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.