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House Bill 5376 (Substitute H-1 as passed by the House)
Sponsor: Representative Mark Tisdell
House Committee: Second Reading
Senate Committee: Finance

Date Completed: 10-27-21

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 would also be retroactive, applying to the 2016, 2017, 2018, and 2019 tax years.

Part 4 Definitions

A term used in Part 4 and not defined differently would have the same meaning as when used in comparable context in the laws of the United States relating to Federal income taxes in effect for the tax year as provided in the IRC unless a different meaning was clearly required. A reference in Part 4 to the IRC would include other provisions of the laws of the US relating to Federal income taxes.

"Flow-through entity" would mean an entity that for the applicable tax year is treated as an S corporation or a partnership under the IRC for Federal income tax purposes. The term would not include a publicly traded partnership, any entity disregarded for Federal tax purposes, or any person subject to the tax imposed under Chapter 13 (the franchise tax for financial institutions). "Internal Revenue Code" would mean the United States Internal Revenue Code of 1986 in effect on January 1, 2021 or, at the option of the taxpayer, in effect for the tax year.

"Person" would mean an individual, bank, financial institution, insurance company, association, corporation, flow-through entity, receiver, estate, trust, or any other group or combination of groups acting as a unit.

"Business income" would mean Federal taxable income and includes payments and items of income and expense that are attributable to business activity of the flow-through entity and separately reported to its members. "Business activity" would mean a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but does not include the services rendered by an employee to his or her employer, services as a director of a corporation or S corporation, or services as a manager of a limited liability company that has elected to file as a C corporation or S corporation for Federal income tax purposes.

"Federal taxable income" would mean taxable income as defined in Section 63 of the IRC (gross income minus the deductions allowed under Chapter 1 (Normal Taxes and Surtaxes) (other than the standard deduction) without the deductions described under Section 703(a)(2) of the IRC (which pertains to deductions not allowed to a partnership).

"Member", when used in reference to a flow-through entity, would mean a shareholder of an S corporation or a partner or member in a partnership.

"Domicile" would mean the principal place from which the trade or business of the flow-through entity is directed or managed.

"Financial institution" would mean that term as defined in Section 651: a) a bank holding company, a national bank, a State chartered bank, a State chartered savings bank, a Federally chartered savings association, or a Federally chartered farm credit system institution; b) any entity, other than an entity subject to the tax imposed under Chapter 12 (tax on the gross premiums of insurance companies), who is directly or indirectly owned by an entity described in a) and is a member of the unitary business group; c) a unitary business group of entities described in a) or b), or both. "Insurance company" would mean that term as defined in Section 607: an authorized insurer as defined in the Insurance Code.

"Tax" would mean the tax imposed under Part 4, including interest and penalties under Part 4, unless the term is given a more limited meaning in the context of Part 4 or a provision of Part 4.

"Tax year" would mean the calendar year, or the fiscal year ending during the calendar year, upon the basis of which the tax base of a taxpayer is computed under Part 4. If a return is made for a fractional part of a year, the term would mean the period for which the return is made. Except for the first return required by Part 4, a taxpayer's tax year is for the same period as is covered by its Federal income tax return. A taxpayer that has a 52- or 53-week tax year beginning not more than seven days before the end of any month is considered to have a tax year beginning on the first day of the subsequent month.

"Taxpayer" would mean a flow-through entity that elects pursuant to the bill to be subject to the tax under Part 4.

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.

"Physical presence" would mean any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity. The term would not include the activities of professionals providing services in a professional capacity or other service providers if the activity were not significantly associated with the taxpayer's ability to establish and maintain a market in Michigan. "Actively solicits" would mean either of the following: a) speech, conduct, or activity that is purposefully directed at or intended to reach people within the State and that explicitly or implicitly invites an order for a purchase or sale; or b) speech, conduct, or activity that is purposefully directed at or intended to reach people within the State that neither explicitly nor implicitly invites an order for a purchase or sale, but is entirely ancillary to requests for an order for a purchase or sale.

"Sale" or "sales" would mean that term as defined in Section 20: all gross receipts of the taxpayer not allocated under Sections 110 to 114 (which allocate various forms of income to the State for purposes of taxation).

Election

For tax years beginning on and after January 1, 2021, a flow-through entity could elect to file a return and pay the tax imposed under Part 4. Except as otherwise provided, the election would be an irrevocable election that would have to continue for the two subsequent tax years and the taxpayer would have to file a return and pay the tax imposed. A flow-through entity that elected to pay the flow-through entity tax would have to file its election with the Department on or before the 15th day of the third month of that tax year; however, an election made for any tax year beginning in 2021 would have to be made before the 15th day of the fourth month after the bill's effective date. A separate election would have to be made after the irrevocable period expired to continue to pay the flow-through entity tax. If, in accordance with the bill, the tax were not levied and imposed during any tax year, for any subsequent tax year that the flow-through entity tax would be levied and imposed, regardless of whether the taxpayer had previously made an election to pay, the taxpayer would be required to make a separate election to pay.

Flow-Through Entity Tax

Beginning January 1, 2021, 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 positive 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% on the taxable income of every person other than a corporation.)

A flow-through entity's negative business income tax base, after allocation or apportionment to the State, would be includible in the business income tax base of each member of the flow-through entity and would not be available as an offset to the allocated or apportioned business income tax of the entity in any other tax year for which an election was made to pay the flow-through entity tax.

The business income tax base would mean 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 IRC.
- Add losses on the sale or exchange of obligations of the US government, the income of which the State is prohibited from subjecting to net income tax, to the extent that the loss had been deducted in arriving at Federal taxable income.
- Deduct, to the extent included in Federal taxable income, income derived from obligations, or the sale or exchange of obligations, of the US government that the State is prohibited from subjecting to net income tax, reduced by interest and expenses incurred in carrying those obligations.
- Add charitable contributions to the extent deducted in arriving at Federal taxable income.
- 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.
- Deduct guaranteed payments for services rendered by a member who was an individual to the extent that those payments were included in Federal taxable income.

- Deduct, to the extent included in Federal taxable income, the amount of refunds received in the tax year based on the taxes paid under the City Income Tax Act or the flow-through entity tax.
- Deduct business income received as a member of another flow-through entity to the extent that income increased Federal taxable income.
- 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 a taxpayer that had a direct, or indirect through one or more other flow-through entities, ownership or beneficial interest in a flow-through entity for which an election was not made, add the taxpayer's share of the non-electing flow-through entity's positive business income.

In computing the flow-through entity tax due, the taxpayer would have to pay the tax due only on the business income tax base allocable to those members who were individuals, flow-through entities, estates, or trusts and would have to exclude the business income tax base allocable to those members that were corporations, insurance companies, or financial institutions. The Department could require the taxpayer to disclose identifying information for all its members and the allocable share of business income for each member.

The tax would be levied and imposed for any tax year that Section 164(b)(6)(B) of the IRC (concerning limitations on individual deductions between 2018 and 2025) limited the amount an individual could deduct under Section 164(a) (concerning state, local, and foreign property, income, and profit taxes, and the GST tax) of the Internal Revenue Code for the same tax year. The tax would not be levied and imposed for any year Section 164(b)(6)(B) did not limit the amount an individual was allowed to deduct under Section 164(a) of the Internal Revenue Code for the same tax year.

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 (which prescribes how various forms of income are allocated to Michigan). 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.

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.

A taxpayer allocated income as a member of a flow-through entity by the entity could not claim a credit against the flow-through entity tax for the taxpayer's allocated share of the tax as reported by the other flow-through entity for the tax year ending on or within the taxpayer's same tax year.

Filing a Return

Except as otherwise provided, 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 in the same manner as provided in Section 301. 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. If the Department considered it necessary to insure payment of the tax or to provide a more efficient administration of the tax, it could require filing of the returns and payment of the tax for other than quarterly or annual periods.

An annual or final return for the flow-through entity tax would have to be filed with the Department in the form and content prescribed by 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. A taxpayer that elected to file a return for three years and whose tax liability under Part 4 was less than or equal to \$100 would have to file an information return.

The Department, upon application of the taxpayer and for good cause shown, could extend the date for filing the annual return. Interest 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 for the annual return would automatically extend the due date until the last day of the sixth month following the original due date of the return. Interest would have to be added to the amount of the tax unpaid for the period of the extension.

A taxpayer required to file a return could be required to furnish a true and correct copy of a return or portion of a return filed under the IRC. 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 180 days after the final determination by the Internal Revenue Service (IRS).

For tax years ending in 2021 only, if a taxpayer were to elect to pay the tax for the tax year ending in 2021 and the annual return filed for that tax year were to result in a refund, that refund would not be subject to added interest under the Revenue Act.

The interest and penalty provided under the bill could not be assessed for the 2022 tax year and each subsequent tax year, if the preceding year's tax liability for the flow-through entity tax were \$20,000 or less and if the taxpayer paid the liability in four equal installments.

Payments made would be a credit against the payment required with the annual tax return required under the bill.

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 annual or final return, upon the amendment of an annual or final return or the adjustment of the tax by the Department, to any member to

which the provision of information was required by the IRC all of the following for the tax year:

- Information regarding the allocation and apportionment of business income under Part 4 and of income subject to tax under Parts 1 and 2.
- The member's allocable share of the reporting flow-through entity's taxes on or measured by net income including the flow-through entity tax for the tax year.
- The member's allocable share of the reporting flow-through entity's refund.
- The member's share of the flow-through entity tax imposed on the taxpayer for the tax year and paid by the deadline prescribed, the member's share of the tax on the taxpayer for any previous tax year and paid within the tax year excluding any amount reported above for the previous tax year, and the member's share of the tax allocated to the reporting flow-through entity by other flow-through entities with tax years ending on or within the reporting flow-through entity's tax year.
- The member's share of the tax allocated above 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.

Estates or Trusts

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 do so would have to report to its beneficiaries their allocable share of the tax imposed under Part 4 and reported to the estate or trust in the same tax year on or before the due date of the return required under Part 1. The allocable share would be calculated by the formula prescribed in the bill.

Administration of the Tax

The Department would have to administer the flow-through entity tax as specified in the bill and the revenue Act. If a conflict existed between the revenue Act and Part 4, Part 4 would apply. The Department could promulgate rules to implement Part 4 under the Administrative Procedures Act. The Department would have to prescribe forms for use by taxpayers and could promulgate rules in conformity with Part 4 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 Part 4, the making of returns, and the ascertainment, assessment, and collection of the tax imposed under Part 4. The tax imposed under Part 4 would be in addition to all other taxes for which the taxpayer could be liable.

The Department would have to prepare and publish statistics 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.

The Department could require the taxpayer to remit any payment due under this part to the Department by an electronic funds transfer method approved by the Department.

Disposition of Revenue

From the flow-through entity tax, that percentage of the gross collections before refunds that was equal to 1.012% divided by the tax rate levied under Part 4 would have to be deposited in the State School Aid Fund and the balance of the revenue collected after that would have to be deposited into the General Fund.

Credits Under Parts 1 & 2

The bill would amend Parts 1 and 2 (which levy the individual income tax and the corporate income tax, respectively) to allow, except as otherwise provided, for tax years beginning on and after January 1, 2021, a taxpayer who either was 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 do so to claim a credit against the flow-through entity tax in an amount equal to the member's allocated share of the tax as reported to the member by the flow-through entity for the tax year ending on or within the taxpayer's same tax year. If the credit exceeded the tax liability of the taxpayer for the tax year, the portion of the credit that exceeded the liability would be refunded.

With respect to Part 1, the bill would allow a nonresident estate or trust, a taxpayer that was an estate or trust, or who was a beneficiary of an estate or trust that was either was 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 do so to claim the credit. The bill would prescribe the method for calculating the credit for each of these entities.

For tax years ending in 2021 only, if the taxpayer claimed a credit under Part 1 or 2 for the flow-through entity tax and the annual return filed Part 1 or 2 on which the flow-through entity tax credit was claimed resulted in a refund, any portion of that refund that was attributable to the credit claimed would not be subject to added interest under the revenue Act.

Student Loan Income Tax Deduction for Disabled Veterans

The Income Tax Act defines "taxable income" as, for a person other than a corporation, estate, or trust, adjusted gross income (AGI) as defined in the IRC, subject to certain adjustments.

Under the bill, for the 2016, 2017, 2018, and 2019 tax years, and for every tax year from 2025 onward, a taxpayer who was a disabled veteran could deduct, to the extent included in AGI, income reported on a Federal income tax form 1099-C attributable to the cancellation or discharge of a student loan by the United States Department of Education under the Total and Permanent Disability Discharge Program. "Disabled veteran" would mean an individual who meets either of the following criteria:

- Has been determined by the United States Department of Veterans Affairs to be permanently and totally disable as a result of military service and entitled to veteran's benefits at the 100% rate.
- Has been rated by the United States Department of Veterans Affairs as individually unemployable.

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.

Fiscal Analyst: David Zin

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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.