

FLOW-THROUGH ENTITY TAX AND DISABLED VETERAN TAX DEDUCTION

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House Bill 5376 as introduced
Sponsor: Rep. Mark Tisdell
Committee: [Placed on second reading]
Complete to 10-13-21

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

SUMMARY:

House Bill 5376 would amend the Income Tax Act by adding a new Part 4, to create a new flow-through entity tax, and by amending provisions in Part 1 (Individual Income Tax) to allow the deduction of certain income attributed to cancellation or discharge of a student loan for disabled veterans.

Flow-through entity tax

The bill would add a new Part 4 to the act, and make 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. [Sec. 254 of Part 1 (Individual Income Tax) and Sec. 675 of Part 2 (Corporate Income Tax)]

The flow-through entity tax part of the bill would be retroactive and effective for tax years beginning on and after January 1, 2021.

Student loan income tax deduction for disabled veterans

Additionally, the bill would amend Part 1 of the act to allow a deduction of some income attributed to cancellation or discharge of a student loan for disabled veterans.

Under the bill, for the 2016, 2017, 2018, and 2019 tax years, and for every tax year from 2025 onward, a taxpayer who is a **disabled veteran** could deduct, to the extent included in adjusted gross income, income reported at the federal level attributable to the cancellation or discharge of a student loan by the U.S. Department of Education pursuant to 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 U.S. Department of Veterans Affairs (VA) to be permanently and totally disabled as a result of military service and entitled to veterans' benefits at the 100% rate.
- Has been rated by the VA as individually unemployable.

The bill's enacting language states that the tax deduction is intended to be retroactive, with the deduction applying to the 2016, 2017, 2018, and 2019 tax years.

MCL 206.30 and 206.623 and proposed MCL 206.254 et seq.

BACKGROUND:

The flow-through entity tax in House Bill 5376 reintroduces a proposal from House Bill 4288 of the 2021-22 legislative session and Senate Bill 1170 of the 2017-18 legislative session,¹ which were both passed by the House and Senate but vetoed by Governor Whitmer and Governor Snyder, respectively.

The student loan deduction provisions are the same as those proposed by Senate Bill 25 of the 2021-22 legislative session. That bill was passed by the Senate and is on third reading in the House.

BRIEF DISCUSSION:

Earlier in 2021, House Bill 4288 was broadly and enthusiastically supported by the business community as a way to provide relief to businesses struggling during the pandemic. The bill was vetoed by the governor, as described above.

In testimony concerning HB 4288, supporters 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 concerning HB 4288, 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 a dozen states have approved the workaround, and the IRS issued guidance in November 2020, effectively allowing it in certain cases.²

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.

The Fiscal Year 2021-22 general omnibus budget³ included a one-time appropriation to the Department of Treasury of \$4.6 million for flow-through entity tax implementation.

FISCAL IMPACT:

Flow-through entity tax

The purpose of these provisions 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

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

² <https://www.irs.gov/pub/irs-drop/n-20-75.pdf>

³ House Fiscal Agency conference report summary of FY 2021-22 general omnibus budget; appropriation on pg. 83. <http://www.legislature.mi.gov/documents/2021-2022/billanalysis/House/pdf/2021-HLA-0082-36AC529E.pdf>

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.

Student loan income tax deduction for disabled veterans

Although these provisions are retroactive for tax years 2016 through 2019, because student loan disability discharges are generally not taxable for tax years 2018 and 2019, the impact of the retroactivity is limited to just tax years 2016 and 2017. Further, since there is a four-year limit on filing amended returns, unless qualified for an extension, the deadline for filing an amended tax year 2016 return has already passed. Therefore, the retroactivity is restricted to tax year 2017 returns, assuming amending returns are filed by April 18, 2022.

Using data from the U.S. Department of Education on student loan discharges during the period between 2014 and 2018 along with 2017 data from the VA to estimate the number of potentially eligible veterans in Michigan, exempting student loan discharges for 100% disabled veterans in tax year 2017 would reduce income tax revenue by about \$350,000. Because filing amended returns to claim the exemption would result in higher refunds, the bill would reduce general fund revenue in the year in which the amended returns are filed.

The federal American Rescue Plan Act exempts student loan discharges through the 2025 tax year, so under the provisions of the bill there would be no revenue impact in Michigan until tax year 2026 (FY 2025-26) for student loans discharged after tax year 2019. At that point, due to projected increases in the number of eligible veterans and student loan debt, the bill would be expected to reduce income tax revenue by about \$1.5 million per year. To the extent that the reduction is realized through gross income tax collections (withholding, estimated payments, and annual payments), the School Aid Fund would absorb about 23.8% of the impact, with the rest coming from the general fund. If the reduction is a result of higher refunds, the impact would be borne by the general fund.

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■ 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.