

FLOW-THROUGH ENTITY TAX

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

House Bill 5376 as enacted

Public Act 135 of 2021

Sponsor: Rep. Mark Tisdell

House Committee: [Placed on Second Reading]

Senate Committee: Finance

Complete to 12-15-22

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

SUMMARY:

House Bill 5376 amends the Income Tax Act by adding a new Part 4, to create a new flow-through entity tax. As defined in the bill, *flow-through entity* means an entity that for the applicable tax year is treated as an S corporation or a partnership under the Internal Revenue Code for federal income tax purposes. It does not include publicly traded partnerships, an entity that is disregarded for federal income tax purposes, or an entity that is subject to tax under Chapter 13 of the Income Tax Act.

The bill adds a new Part 4 to the act, and makes 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 elects to pay the new flow-through entity tax, unless otherwise prohibited by federal law. (If the tax credit exceeds the taxpayer's liability, the difference must be refunded. For tax years ending in 2021 only, any refund attributable to the credit is not subject to added interest under 1941 PA 122, known as the revenue act.) The same applies to a nonresident estate or trust, except that the credit is adjusted to account for the current state income tax rate.
- Provide that the above tax is levied and imposed for any tax year that section 164(b)(6)(B) of the federal Internal Revenue Code limits the amount an individual is allowed to deduct under section 164(a) of the Internal Revenue Code for the same tax year, and is not imposed and levied for any tax year in which that is not the case.
- Prescribe how a flow-through entity electing to pay the new tax must file its election with the Department of Treasury and provide that the election is irrevocable for the next two tax years. However, if the tax is not levied during any tax year, a taxpayer must make a separate election for any subsequent tax year the tax is levied, regardless of whether the taxpayer had previously made an election.
- Specify that the flow-through entity tax must be imposed on the positive business income allocated or apportioned to Michigan subject to certain adjustments made prior to allocation or apportionment to Michigan.
- 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 is subject to tax in another state.
- 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.

- Require a taxpayer that reasonably expects its tax liability to exceed \$800 to file an estimated return and pay an estimated tax for each quarter of the tax year.
- 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 is 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 must be added to the amount of the tax unpaid for the period of the extension.
- Allow the Department of Treasury to require copies of federal income tax returns and require amended returns to be filed with the department.
- Allow the Department of Treasury to require a taxpayer to remit any payment due under the new chapter by an approved electronic funds transfer method.
- Require a flow-through entity that does not elect 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.
- 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.
- Provide that the bill's provisions prevail if they conflict with the revenue act.
- 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 must 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.
- 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.

The bill authorizes a taxpayer who was a member or indirect member of a flow-through entity that elects 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 will be refunded if it exceeds the taxpayer's tax liability.

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

MCL 206.30 and 206.623 (amended) and MCL 206.254 et seq. (added)

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 both were passed by the legislature but vetoed by Governor Whitmer and Governor Snyder, respectively.

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

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

The fiscal year 2021-22 general omnibus budget,³ passed in September 2021, included a one-time appropriation to the Department of Treasury of \$4.6 million for flow-through entity tax implementation.

FISCAL IMPACT:

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 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 will be distributed in the same way as revenue collected under the individual income tax in Part 1, there will be no impact on either total revenue or the amounts accruing to the School Aid Fund and the general fund.

Legislative Analyst: Alex Stegbauer
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.

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>