



Senate Fiscal Agency
P.O. Box 30036
Lansing, Michigan 48909-7536



Telephone: (517) 373-5383
Fax: (517) 373-1986

Senate Bill 195 (Substitute S-1 as passed by the Senate)
Sponsor: Senator Aric Nesbitt
Committee: Finance

Date Completed: 8-22-22

RATIONALE

The Federal Tax Cuts and Jobs Act, which took effect on December 22, 2017, amended the Internal Revenue Code (IRC) to revise tax rates and credits for United States taxpayers. One of the revisions limited the amount of interest expenses that may be deducted from corporate income. While this broadened the tax base, the Act included a rate reduction that offset this increase, resulting in a tax cut at the Federal level. For the purpose of calculating the State's Corporate Income Tax (CIT), Michigan generally defines taxable income as that term is defined under Federal law. Thus, with the Tax Cuts and Jobs Act, the State's tax base also was widened; however, there was no concurrent reduction in the tax rate. Moreover, subsequent Internal Revenue Service regulations evidently have allowed unitary business groups to treat interest expenses in a manner that differs from the Michigan Department of Treasury's enforcement of the CIT by allowing interest expenses to be claimed at a group level instead of at an entity level.

Because of this combination of factors, Michigan businesses claim they have seen an increase in their State income tax liabilities that will affect Michigan's business climate. In order to address these issues, it has been suggested that the State allow entities within a unitary business group (i.e., a group of two or more corporations, insurance companies, or financial institutions that satisfy both a control test and one of two relationship tests, and that is treated as a single taxpayer) to share their deductible business interest expenses on a group-wide basis.

CONTENT

The bill would amend the Income Tax Act to prescribe a formula that would apply, beginning with the 2021 year, for determining a person's Federal taxable income under the corporate income tax and for applying the business interest expense limitation under the Federal income tax, if the person were included in a unitary business group.

The bill states that it is intended to be retroactive and would apply retroactively beginning on and after the 2021 tax year.

Definitions

"Business interest" would mean that term as defined in Section 163(j) of the IRC. "Business interest carryforward" would mean the amount of a person's excess business interest not deducted for the tax year by any person included in a unitary business group and is treated as business interest paid or accrued in the succeeding tax year. "Business interest limitation" or "limitation" would mean the limitation imposed under Section 163(j) of the IRC. (Section 163(j) of the IRC pertains to the limitations on business interest deduction, which may not exceed the sum of business interest income of a taxpayer for a taxable year, 30% of the adjusted taxable income of a taxpayer for a taxable year, and the floor plan financing interest of a taxpayer for a taxable year.)

Determination of Taxable Income; Unitary Business Group

Except as otherwise provided, a unitary business group must file a combined return that includes each United States person that is included in the unitary business group. Each United States person included in a unitary business group or a combined return must be treated as a single person, and all transactions between those entities included in the unitary business group must be eliminated from the corporate income tax base, the apportionment formulas, and for purposes of determining exemptions, credits, and the filing threshold under Part 2 of the Income Tax Act (which provides for the CIT).

Beginning with the 2021 tax year, to determine a person's Federal taxable income under Part 2 and applying the Section 163(j) of the IRC, if that person were included in a unitary business group then the provisions below would apply.

If a person met any of the following conditions, that person would not be subject to the business interest limitation for the tax year:

- The person's business interest deduction was not limited under the IRC for that tax year.
- The person was exempt from the business interest limitation under the IRC for that tax year.
- The person was engaged or treated as engaged in an excepted trade or business under the IRC for that tax year.
- The person was included in an affiliated group that made a Federal consolidated return under the IRC for that tax year and that met at least one of the above conditions.

To the extent a person had excess business interest, that person's excess business interest would have to be deducted by other entities included in the unitary business group to the extent those other entities had unused business interest limitation. The taxpayer could decide how to share any excess business interest among the entities included in the unitary business group. After the application of this provision, and except as otherwise provided below, the following would apply:

- Any excess business interest remaining would become the person's business interest carryforward.
- If a person departed a unitary business group, any business interest carryforward attributable to that person would remain with that person and not with the unitary business group; if that person were subsequently included in another unitary business group, that business interest carryforward would have to be shared as specified above.

"Excess business interest" means the amount of a person's separately determined business interest not deducted by that person for the tax year due to the separately determined limitation calculated under Section 163(j)(1) of the IRC. "Separately determined" would mean determined under the IRC as if the person is treated as a single person and not as a member of an affiliated group making a federal consolidated return under Chapter 6 of the IRC. "Unused business interest limitation" would mean the excess of a person's separately determined limitation over that person's separately determined business interest.

Business interest paid or accrued in the current tax year would have to be deducted before business interest carryforwards. Business interest carryforwards would have to be used in the order of the tax year in which they arose, beginning with the earliest year.

For purposes of eliminating transactions between those in the unitary business group, if a person's separately determined business interest or business interest carryforward were limited and any portion of that business interest was paid or accrued to another person included in the unitary business group, the interest paid or accrued to those within the unitary business group would have to be deducted before interest paid or accrued to those outside the unitary business group. A person that departs a unitary business group would not be entitled to any business interest carryforward attributable to business interest paid or accrued to those within the business group.

BACKGROUND

The Federal Tax Cuts and Jobs Act imposed a limitation on the deduction of business interest expense effective beginning with the 2018 tax year. Subsequently, the Coronavirus Aid, Relief and Economic Security (i.e., CARES) Act amended the business interest expense limitation for tax years beginning in 2019 or 2020. Business interest expense is deducted in arriving at Federal taxable income, and an entity's Federal taxable income is used in the computation of that entity's Michigan CIT liability.

Generally, all interest paid or accrued is deductible; however, as noted above, under 26 USC 163(j), business interest expenses are deductible only up to the sum of the following: a) the business interest income of a taxpayer for that taxable year, b) 30% of the adjusted taxable income of that taxpayer for such taxable year, and c) the floor plan financing interest of that taxpayer for that taxable year (which applies only to those taxpayers who have used debt to finance the purchase of automobiles, tractors, or boats). The limit does not apply under certain circumstances, and any excess deduction beyond this limit may be carried forward in subsequent tax years indefinitely. In 2020, the Michigan Department of Treasury issued a notice indicating that (simply stated) individual entities within a unitary business group must calculate their business interest expenses individually.¹ This is different from Federal regulations, which allow those entities to calculate the expenses at a group level.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

According to testimony provided before the Senate Committee on Finance, because of the way Michigan's CIT is tied to Federal law, the Tax Cuts and Jobs Act combined with Michigan's administration of the CIT effectively raised Michigan businesses' tax liabilities to the State. Foreign direct investment is critical to the Michigan economy. According to the Organization for International Investment, international companies employ 317,000 Michiganders and jobs provided by international companies grew by 33% over the last five years. The ability to deduct interest as an ordinary and necessary business expense encourages investment and expansion. If Michigan fails to enact Senate Bill 195, the State would continue to limit interest deductibility and would require entities within unitary business groups to calculate their own interest expenses, which would raise the cost of capital and increases taxes on Michigan employers. Other states, such as Minnesota, Georgia, Indiana, Tennessee, and Wisconsin, have enacted measures to address this issue, effectively making those places more attractive for business and leaving Michigan the only state for which this discrepancy exists. The bill would ensure that international companies has an incentive to invest across the State and that Michigan remained an attractive place for business.

Legislative Analyst: Jeff Mann

FISCAL IMPACT

The bill would reduce State General Fund revenue by approximately \$10.0 million per year, according to the Michigan Department of Treasury. The estimate is based on Federal data, but because there are differences between Federal and State rules and statute as to which members are included in unitary business groups, the estimate has a relatively large margin of error. The

¹ Michigan Department of Treasury Notice, "Corporate Income Tax Treatment of the IRC 163(j) Business Interest Limitation", 6-8-2020.

inclusion or exclusion of certain members relative to current law could reduce or increase tax liabilities, depending on the specific circumstances of the group members. The bill would affect only CIT 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.