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Senate Bill 150 (as passed by the Senate)

Sponsor: Senator Vernon Ehlers

Committee: Finance

Date Completed: 6-14-89

RATIONALE**Dependent Exemption**

The 1986 Federal Tax Reform Act removed the ability of dependents, mostly minors, to claim a personal exemption for themselves if they are claimed as a dependent by another taxpayer. For Federal tax purposes, loss of the personal exemption was offset by lower tax rates and, for non-itemizers, an increased standard deduction. The loss of the personal exemption, however, increased State income tax liabilities for such persons since State tax forms are based on Federal tax calculations; persons can claim on their State tax form only the number of exemptions they claim on their Federal form. This meant that, without the personal exemption, a dependent's income became taxable from the first dollar earned. In response to this situation, the Legislature passed Public Act 1 of 1988 to provide that, beginning with the 1987 tax year, a person who had a Federal adjusted gross income (AGI) of \$1,500 or less and was a dependent would be exempt from State income tax liability. While this action helped those persons who earned \$1,500 or less, it did nothing for dependents who earned over \$1,500--a dependent who earned \$1,600, for instance, had to pay tax on that amount from the first dollar earned because he or she could not claim a personal exemption.

In response to this, Public Act 516 of 1988 was passed to provide that a dependent subject to the State income tax could deduct up to \$500 from taxable income for the 1988 tax year, and \$1,000 for the 1989 tax year and thereafter. (Example: A dependent who earned \$1,500 in 1988 was not taxed, but a dependent who earned \$1,800 was liable for tax on \$1,300. [\$1,800 - \$500 = \$1,300]) Some people feel

that, while Public Act 516 helped dependents, more needs to be done to restore the value of the personal exemption as it existed before passage of the 1986 Federal Act.

Lottery Tax

Public Act 516 of 1988 also requires taxpayers to include lottery prizes as ordinary income, beginning with the 1988 tax year. Prior to the passage of Public Act 516, taxpayers were allowed to exempt lottery winnings from State and local taxes; winnings have always been subject to Federal income taxes. Some people argue, however, that the taxing of lottery prizes should not have been retroactive, that is, should not have applied to prizes that were won in 1988 or previous years. In fact, lawsuits reportedly have been filed against the State to challenge the ability of the State to tax lottery prizes awarded in 1988 or beyond but won in 1988 or previous years. It has been suggested that the tax on lottery prizes should apply only to prizes won after January 1, 1989.

Business and Moving Expenses

Before the 1986 Federal Tax Reform Act, certain business and moving expenses were excluded from the computation of Federal AGI, either because they were not included as income or because they were deducted after the computation of AGI. Since State taxes are based upon AGI, these expenses were not subject to State taxes. The 1986 Federal Act, however, requires inclusion of these expenses in AGI. Although other changes limited the affect this had on taxpayers' Federal tax payments, these expenses are now subject to State income taxes. It has been pointed out that this change has been particularly burdensome to

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salespersons and employees who are not reimbursed for business and moving expenses, but are required to include those expenses as part of AGI. Some people feel that persons should be allowed to deduct from State taxable income amounts up to the amounts deducted or excluded from AGI for business and moving expenses under the Internal Revenue Code.

CONTENT

The bill would amend the Income Tax Act to increase the deduction dependents may take; allow a deduction for lottery prizes won before 1989; and allow a deduction for certain business and moving expenses.

Dependent Exemption

The bill provides that a person who is not allowed to claim a personal exemption under the Internal Revenue Code (i.e., a dependent) could deduct from taxable income \$1,500 for the 1989 tax year. Subsequently, the \$1,500 amount would be increased each tax year by the increase in the Detroit Consumer Price Index, with the result rounded to the nearest \$50. The \$1,500 amount could not be increased to an amount that exceeded the standard personal exemption (\$2,100 for tax years after 1989).

Lottery Tax

The bill would allow a taxpayer to deduct, to the extent included in Federal adjusted gross income, money received as a result of a State lottery prize won before January 1, 1989. The bill would strike from the Act a provision that requires taxpayers to include, for the 1988 tax year and thereafter, lottery prizes as ordinary income. Prizes won after January 1, 1989, then, would be subject to the State income tax.

Business and Moving Expenses

The bill would allow a taxpayer to deduct from taxable income, to the extent not deducted in calculating Federal adjusted gross income, certain trade and business expenses of employees that were allowed as deductions under Section 62 of the Internal Revenue Code as it read before the Federal Tax Reform Act of 1986. (Under the former Section 62, an employee could deduct from gross income:

reimbursed expenses paid or incurred by the employee in connection with the performance of services as an employee; expenses of transportation, travel, meals, and lodging while away from home in the performance of services as an employee; and expenses attributable to a trade or business carried on by the taxpayer if the trade or business consisted of the performance of services as a solicitor away from the employer's place of business.)

Further, the bill would allow a taxpayer to deduct the amount paid or incurred during the year for employment-related moving expenses (that is, expenses incurred in connection with the commencement of work by the taxpayer as an employee or self-employed person at a new principal place of work) up to the amount that would qualify for the moving expense deduction under Section 217 of the Internal Revenue Code. (Section 217 allows a deduction for expenses (a) of moving household goods and personal effects; (b) of traveling to the new residence; (c) of traveling, after obtaining employment, between the former residence and the new place of work, to locate a new residence; (d) of meals and lodging in temporary quarters in the new location for 30 days after obtaining employment; and (e) constituting qualified residence sale, purchase, or lease expenses. In general, Section 217 sets a limit of \$1,500 on the deduction for expenses under (c) and (d) together, and a limit of \$3,000 for expenses under (e) minus the amount allowed for (c) and (d) expenses.)

MCL 206.30

FISCAL IMPACT

The bill would lead to a reduction in GF/GP revenues of \$50 million to \$55 million in FY 1989-90, rising to \$75 million to \$80 million in future years.

ARGUMENTS

Dependent Exemption

Supporting Argument

Because of changes made by the Federal Tax Reform Act of 1986, some taxpayers have found that their treatment under the State Income Tax Act has been worsened. For instance, minors or others who can be claimed

as a dependent by another taxpayer for the purpose of Federal taxation can no longer claim a personal exemption against the State income tax. This is an especially burdensome tax for students who can be claimed by their parents as dependents but need to earn as much money as possible to help themselves get through school. While Public Act 1 of 1988 alleviated the problem somewhat by exempting dependents who earn \$1,500 or less, it failed to restore the personal exemption for those dependents who make more than \$1,500. In effect, the Act created a tax precipice: a dependent earning \$1,500 was exempt but a dependent earning \$1,501 was liable for tax on the entire amount. Public Act 516 of 1988 lessened the problem somewhat by allowing a \$500 deduction in 1988 and a \$1,000 deduction in 1989; however, the measure still falls short of treating dependents as they were treated prior to the passage of the 1986 Federal Act. The bill would help to restore fairness to the State's income tax regarding dependents.

Opposing Argument

Passage of the 1986 Federal Act resulted in many changes for the State's taxpayers and caused an increase in revenue collections under the State income tax. In response to this increase in taxation, a broad-based solution was adopted to minimize increased collections by increasing the personal exemption for all taxpayers except dependents, and exempting those dependents with an income under \$1,500. There could be numerous examples in which quirks in the Income Tax Act, as affected by the changes in Federal taxes, have caused individual groups of taxpayers to experience slight or moderate tax increases. Rather than address the problems of each group, it was decided to return money to the taxpayers by trying to reduce everybody's tax liability. If each group of taxpayers that was affected by the changes now tried to address its problems separately, the entire Act would have to be restricted and, likely, the increased personal exemption would have to be reduced because the changes would significantly reduce State revenues.

Response: The issue is whether the State should return money to those who, through no effort of the State or its decision-makers, have had their taxes increased. If one group of taxpayers (such as dependents) is treated differently than another group, the laws should

be adjusted to equalize the situation. The current system of not taxing those who earn less than \$1,500, but taxing those who earn \$1,501 is inequitable and only encourages cheating.

Lottery Tax

Supporting Argument

As a simple matter of fairness, the State should not tax the lottery winnings of persons who played lottery games and won prizes at a time when the State was prohibited from taxing lottery winnings. Passage of the retroactive tax on lottery winnings not only was unjust, it was an action that sent a harsh message to the residents of the State. The message was that the State runs the games and it makes the rules, and even if a person is fortunate enough to beat the tremendously low odds, the State can for its own convenience change the rules to diminish the amount winners thought they would be allowed to keep. The State should rescind the retroactive lottery tax before it is entangled in a mesh of legal challenges, and show the public that the State can forego some revenue for the sake of fairness.

Opposing Argument

The tax on lottery prizes was passed along with several other amendments that reduced income tax revenue. Public Act 516 also allowed low-income seniors, beginning in tax year 1989, to claim a credit for the cost of prescription drugs; in addition, it granted a \$500 deduction for dependents who earn over \$1,500 in 1988 and a \$1,000 deduction for 1989 and beyond. Applying the tax on lottery winnings to only those prizes won after 1988 would drastically reduce the revenues the State had expected to be generated from the tax. If the bill is passed, other sources of revenue should be found to counteract its effect.

Opposing Argument

The tax is retroactive only to the extent that it taxes prizes awarded in 1988 but won in previous years--it does not apply to prizes awarded before 1988. While the State has had a prohibition against the taxing of lottery winnings since the lottery's inception, the prohibition has been viewed by some as an unfair and unnecessary restriction on the State's ability to tax income. The levying of the 4.6% income tax on lottery winners cannot

be viewed as a tax that causes a hardship on the taxpayers. A person who won \$1 million would, absent all deductions, be subject at the most to a tax bill of \$46,000 over the 20 years in which the prize was awarded.

Business and Moving Expenses

Supporting Argument

Many persons who have business and moving expenses have found their State tax liabilities increased substantially because these items are now included as part of AGI. This change has been particularly unfair to salespersons and employees who have unreimbursed business and moving expenses; in effect, these taxpayers must include the expenses as part of their income and thus pay taxes on those expenses without receiving reimbursement, while other employees with similar positions pay those taxes but are reimbursed. The bill would correct this inequity and restore the tax treatment of business expenses to a position similar to its status prior to the 1986 Federal Act.

Opposing Argument

Once again, there could be numerous examples in which quirks in the Income Tax Act, as altered by changes in Federal taxes, have caused individual groups of taxpayers to experience slight or moderate increases in taxes. Rather than address each change separately, it was decided to increase the personal exemption and return money to taxpayers by reducing everyone's tax liability. Allowing deductions for business and moving expenses would reduce State revenues, and if this change were adopted there should be a corresponding action to replace that revenue.

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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.