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Senate Bill 7 (Substitute S-2 as passed by the Senate)**Sponsor: Senator Norman D. Shinkle****Committee: Finance****Date Completed: 4-17-87****RATIONALE**

The Federal Tax Reform Act of 1986 made major changes in the way taxpayers will calculate their Federal income tax liabilities. Because a majority of states base the computation of State income tax liability on the provisions of Federal tax laws, the Act will also affect States' revenue collections. In Michigan, taxpayers begin the calculation of their State income tax by using the result obtained in the computation of adjusted gross income (AGI) on their Federal tax form. Because Federal tax changes eliminate or reduce many of the deductions used to calculate AGI, it has been projected that individuals' AGI will increase, thus increasing the amount subject to Michigan's 4.6% income tax rate. The Department of Treasury has estimated that Federal tax changes will result in a revenue increase to the State of \$170 million (after the changes are fully phased-in, based on 1986 income levels). Some people feel that this projected revenue increase is a "windfall"—money the State did not plan or expect to obtain—and should therefore be returned to the taxpayers. The Governor proposed in 1986, and reiterated in his State of the State message this year, that the State income tax rate be reduced to return to the taxpayers any increase in revenues resulting from Federal tax reform.

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The bill would amend the Income Tax Act to lower the income tax rate from 4.6% to 4.4% of taxable income, effective April 1, 1987.

The bill also would require the State Treasurer to increase the "annualized" income tax rate by up to .05 percentage points, if it were determined that amendments to the Federal Tax Reform Act, made between January 1 and October 1 of this year, resulted in a net reduction in State income tax revenues for fiscal year 1986-87. (The "annualized" tax rate for a year is determined by the Department of Treasury. It compares the various tax rates that have applied during the year, in proportion to the length of time they have been in effect, resulting in one annualized rate for the year. Thus, under the bill, the tax rate of 4.6% would apply from January 1 to April 1, and 4.4% would apply from April 1 to December 31, resulting in an annualized rate of 4.45%. Under the amendment, that rate could be raised up to an additional .05%.)

The bill is tie-barred to Senate Bill 98 and Senate Bill 8. Senate Bill 98 would amend the Income Tax Act to provide that references to the Internal Revenue Code refer to the latest version of the Code. Senate Bill 8 would amend the Income Tax Act to allow a taxpayer to claim an additional personal exemption if he or she were blind, or had received unemployment compensation equal to 50% or more of household income.

MCL 206.51

FISCAL IMPACT

The passage of Senate Bill 7 would reduce GF/GP revenues by \$85 million in FY 1986-87 and \$178 million in FY 1987-88. If the State Treasurer increased the rate .05 percentage points in FY 1986-87, the GF/GP revenue loss would be \$43 million in FY 1986-87 and \$178 million in FY 1987-88.

ARGUMENTS**Supporting Argument**

The State income tax rate needs to be lowered in order to ensure that the State doesn't unfairly benefit from the effects of Federal tax reform. It has been established that Federal tax changes will cause the State to realize a revenue gain of approximately \$170 million. If the State fails to take action to place this money back in taxpayers' pockets, it can be argued that the State has, in effect, increased taxes. In recent years, through the payment of increased income taxes, the people of Michigan did their part to help Michigan regain its economic stability. It is only right, now that the books have been balanced and the debts paid, that this windfall be returned to the taxpayers.

Opposing Argument

The State should not rush into an income tax reduction without studying the results more closely. Many of the Federal tax changes are to be phased-in gradually over the next few years, meaning that while a State income tax reduction would start reducing State revenues April 1, the revenue gained would not arrive at the same time. In addition, there are those who claim that because of the many complicated factors involved, the amount of actual revenue gain will never really be determined. Further, proposals before Congress to alter the effective dates of tax changes could substantially affect any estimates.

A premature rollback, by reducing revenues, could threaten the progress Michigan has made in recent years and lessen its ability to cope with future recessions or problems. Before the State takes action on disposing of any revenue "windfall", it needs to consider such issues as property tax reform, school financing, increased funding to urban areas or to local governments that may feel the effects of reduced Federal revenue sharing, or bolstering long-neglected human services.

Response: The bill contains a provision that would require the Treasurer to adjust the annualized income tax rate upward slightly if changes are made in current Federal tax laws. The notion that the State should keep any revenue

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gain, in case it finds itself in difficulty later, or needs a quick solution to a problem, places the State's interests ahead of its citizens. The most important consideration at this time should be to return the money to the people as soon as possible.

Opposing Argument

Returning the windfall to the citizens, while commendable, should be done carefully after thorough study. Though an income tax rate reduction would effectively disperse the revenue, it may not be the fair way to return it to those who are most affected. As a result of the Federal tax changes, blind persons and senior citizens, for example, lose the double exemption that they now claim under the Internal Revenue Code. Because of this loss, it has been projected that seniors will end up paying more State income tax, up to \$29 million more, according to testimony by the American Association of Retired Persons. It has been suggested that the State could retain its double exemption, and thus avoid harm to the blind and seniors. Further, unless other action is taken, the State will now tax all unemployment compensation, and eliminate capital gains exclusions: each item, according to the Department, would result in the State's gaining around \$15 million in additional revenue. By simply reducing the tax rate, the bill would do little to restore money to those who, because of provisions in the new Federal tax law, will end up paying for a substantial portion of the windfall.

Response: The question of who is paying the extra taxes that will cause the windfall, and whether they should receive a dollar-for-dollar reimbursement for their efforts, is an enormously complicated issue that, even with extensive study, may not lend itself to definitive answers. The bill proposes a simple, quick way to disperse excess State revenue, and is preferable to the lengthy battle that would likely ensue if the Legislature were required to pick and choose who got a tax break and who did not.

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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.