SFA BILL ANALYSIS

Senate Fiscal Agency • Lansing, Michigan 48909 • (517) 373-5383

House Bill 4816 (Substitute H-2 as reported with amendments)
Sponsor: Representative David M. Gubow
House Committee: Taxation
Senate Committee: Finance

Date Completed: 11-28-88

RATIONALE

The Intangibles Tax Act imposes a tax on intangible personal property, such as shares of stock, land contracts, bonds, and securities. Shareholders in regular corporations and S corporations are taxed in the same manner under the Act, while income from partnerships is excluded from taxation. (S corporations did not exist when the intangibles tax was enacted.) Some people feel that subjecting S corporation shareholders to the intangibles tax is improper, pointing out that S corporations are much like partnerships for purposes of Federal taxes.

Because of the restrictions placed on S corporation structure (see BACKGROUND), it is claimed, S corporations tend to be small, family-operated businesses that attract active, rather than passive, investors — a similarity to partnerships. Also, it has been argued that the intangibles tax discourages the creation of S corporations in Michigan because, in effect, some earnings can possibly be taxed three times. The shareholder must pay the intangibles tax on the shares held and the State income tax on earnings from the shares, and the corporation must pay the single business tax. Others say, however, that a complete exemption from the intangibles tax would ignore the argument that S corporations enjoy overall tax advantages that other forms of business organizations do not. A compromise has been suggested that would allow S corporations a partial exemption from the intangibles tax.

CONTENT

The bill would amend the Intangibles Tax Act to allow a taxpayer, who is required by the Internal Revenue Code to determine Federal income tax liability by calculating his or her pro rata share of the income of an S corporation, to claim a deduction equal to the lesser of: 1) the amount included as income due to a distribution by the S corporation, or; 2) 10% in tax year 1988, 15% in tax year 1989, and 20% in tax year 1990 and beyond, of the taxpayer's share of the S corporation income.

Proposed MCL 205.133a

BACKGROUND

Under the Internal Revenue Code, an S corporation is defined as a small business corporation for which an election to be an S corporation is in effect. A small business corporation is defined as a domestic corporation that does not: have more than 35 shareholders; have more than one class of stock; have a shareholder, other than an estate or trust, who is not an individual; and, have a shareholder who is a nonresident alien. A small business corporation elects to be an S corporation by consent and election of the shareholders according to procedures in the Code. An election can be terminated in any one of three ways: shareholders holding more than one-half of the shares consent to revocation of the election; the corporation ceases to be a small business corporation; or, certain types of investment income exceed 25% of gross receipts for three consecutive taxable years.

SENATE COMMITTEE ACTION

The Senate Finance Committee adopted amendments to the bill as passed by the House that would make changes described as technical.

FISCAL IMPACT

The Department of Treasury estimates that House Bill 4816 would result in a decrease in General Fund/General Purpose revenue of $2.5 to $3 million in 1988, $3.8 to $4.4 million in 1989, and $5 million to $5.9 million in 1990.

ARGUMENTS

Supporting Argument

The current imposition of the intangibles tax on shareholders of S corporations is unfair to shareholders and bad for business in Michigan. In addition to S corporation earnings' being taxed at 2.35% under the single business tax, shareholders must pay a 4.6% income tax and a 3.5% intangibles tax on distributions. This is a burdensome tax structure, and a discouragement to the formation of S corporations at a time when firms that are eligible to form an S corporation have an incentive to do so. Under the Federal Tax Reform Act of 1986, the highest marginal tax rate to individuals is 28%, while the highest marginal rate on regular corporations is 34%. Because S corporation earnings under Federal law are considered passed through to the shareholders, the earnings are taxed at the 28% rate. It is clearly an advantage for an eligible firm to choose S corporation status to reduce the Federal tax burden on the shareholders; however, the intangibles tax works against this logic.

S corporations are treated much like partnerships for Federal tax purposes. Further, because of the limits placed on their structure, S corporations tend to attract shareholders who are active in the firms as partners are active in partnerships. By reducing S corporation liability for the intangibles tax, the bill would provide for a more consistent State tax policy.

Opposing Argument

The intangibles tax is a proper tax and should continue to be levied on S corporation disbursements, and partnerships and S corporations should continue to be treated differently

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for tax purposes. Partnerships are exempted under the Act because disbursements are not treated as capital but as wages and benefits; that is, the partners actively participate in the actions of the firm and are paid for their participation. S corporation shareholders, on the other hand, don't necessarily have to participate in the activity of a firm; even though Federal tax law places a ceiling on the passive investment income earned by an S corporation, shareholders can be passive members of the corporation. In fact, the Department of Treasury reports that S corporation earnings that are disbursed to active shareholders as wages or benefits, instead of shareholder dividends, are not subject to the intangibles tax. This weakens the contention that all shareholders in S corporations are burdened by the intangibles tax, because those shareholders who receive disbursements as wages and benefits are already not subject to the tax.

It must be remembered that the intangibles tax is a tax based on the ownership of intangible personal property, not on income. Saying that it is an unfair tax is like saying that those who pay income tax should not have to pay sales tax when they spend the income; these are two entirely separate and proper taxes. In addition, the claim that S corporations are subject to single business tax liability deserves further study. Many S corporations are small businesses, and many small businesses pay little or no single business tax. Also, the Single Business Tax Act contains special credits that S corporations can claim. It may be that there are few S corporations that have significant single business tax liabilities.

Opposing Argument

The State can little afford the lost revenue that the bill would cause, and would be ill-advised to erode its tax base further.

Response: While reducing S corporation shareholders' liability for the intangibles tax would reduce that tax revenue, increased income tax revenues would be expected because of the increased numbers of firms organizing as S corporations; while the disbursements of regular corporations only are subject to the income tax, all the earnings of an S corporation would be taxed as income because they pass through to the stockholders.

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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.