Legislative Analysis

GOVERNOR'S FY 2006 BUDGET: TAX CHANGES

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House Bills 4905-4907
Sponsor: Rep. Paul Condino

House Bill 4908
Sponsor: Rep. Steve Bieda

House Bills 4909 and 4952
Sponsor: Rep. Fred Miller

House Bill 4910
Sponsor: Rep. Barbara Farrah

House Bill 4911
Sponsor: Rep. Paula Zelenko

House Bills 4912-4914
Sponsor: Rep. Andrew Meisner

House Bills 4951 and 4953
Sponsor: Rep. Lee Gonzales

Committee: Tax Policy
Complete to 7-21-05

A SUMMARY OF HOUSE BILLS 4505-4914 AS INTRODUCED 6-9-05 AND HOUSE BILLS 4951-4953 AS INTRODUCED 6-16-05

As part of the Executive Budget recommendation for Fiscal Year 2006, Governor Granholm has proposed eliminating nine tax expenditures related to marginal wells, international and certain interstate communications, interstate trucks and trailers, water softeners and coolers, railroad property, copyrighted motion pictures, oil and gas royalty income, food sold through vending machines, and purchases made by correctional inmates. Legislation incorporating the governor's tax plan has been introduced.

House Bills 4905-4907: Rolling Stock - Trucking

The General Sales Tax Act exempts from taxation, the sale of rolling stock (certain large trucks, trailers, and related parts) purchased by or rented or leased to an interstate motor carrier and used in interstate commerce. <u>House Bill 4905</u> would eliminate this exemption beginning October 1, 2005. (MCL 205.54r)

The Use Tax Act similarly exempts the storage, use, or consumption of rolling stock purchased, rented, or leased by an interstate motor carrier fleet. <u>House Bill 4906</u> would eliminate this exemption beginning October 1, 2005. (MCL 205.94k)

Under both acts, an interstate motor carrier is defined to mean a person engaged in the business of carrying persons or property – other than themselves, their employees, or their own property – for hire across state lines, and whose fleet mileage was driven at least 10 percent outside of the state in the immediately preceding tax year.

House Bill 4907 would amend the Streamlined Sales and Use Tax Revenue Equalization Act to provide interstate motor carriers with a credit against the sales and use taxes for sales or use taxes paid on the purchase, rental, lease, or use of rolling stock used in interstate commerce, based on the miles driven outside of Michigan. (MCL 205.180)

Under current law, rolling stock is totally exempt from sales or use taxes if at least 10 percent of the fleet mileage is outside of Michigan. House Bill 4907 would essentially tax rolling stock in proportion to its use in Michigan.

The credit would be computed as follows:

6%	**x**	Miles Outside Michigan / Total Miles for Interstate Commerce *(Would not include exclusive intrastate miles)*	**x**	Price of Rolling Stock

In 1984, the Department of Treasury issued a position statement (SUW 84-003) on the sales and use tax treatment of interstate motor carriers. In accordance with SUW 84-003, the Department of Treasury, beginning January 1, 1985, provided interstate motor carriers domiciled in Michigan with a refund of sales and use taxes paid on rolling stock used in interstate commerce, based on their percentage of out of state mileage. In September 1989, the Court of Claims invalidated the refund provisions in SUW 84-003 finding those provisions to be without statutory authority. Following the court's decision, and a similar decision in 1992, rolling stock became subject to the sales and use taxes. In 1995, the state Court of Appeals ruled in *Gainey Transportation Service, Inc. v. Department of Treasury* (209 Mich App 504) that the Department of Treasury did not have the authority under the Revenue Act or the General Sales Tax Act to provide a refund in SUW 84-003.

In response to the *Gainey* decision, the legislature and governor enacted Public Act 477 of 1996 providing a use tax exemption for the storage, use, or consumption of rolling stock used interstate commerce and purchased, rented, or leased outside of the state by an interstate motor carrier. Additionally, the legislature and governor enacted Public Act 576 of 1996, providing a sale tax exemption for certain trucks and trailers (though not affixed parts), based on the percentage of miles used out of state. The taxation of rolling stock, it was argued, placed Michigan trucking businesses at a competitive disadvantage compared to businesses domiciled in neighboring states that do not tax rolling stock. Public Acts 70 and 116 of 1999 extended indefinitely a sunset date of May 1, 1999 provided in the 1996 acts, and PA 116 also extended the sales tax exemption to include parts affixed to trucks and trailers.

House Bills 4908 and 4911: Copyrighted Motion Pictures & Inmate Purchases

House Bill 4908 would amend the General Sales Tax Act to eliminate 1) an exemption for the sale of a copyrighted motion picture and 2) the sale of tangible personal property to inmates in a penal or correctional institution purchased with scrip or its equivalent issued and redeemed by the institution. The exemptions would be eliminated beginning October 1, 2005. (MCL 205.54a)

House Bill 4911 would amend the Use Tax Act to eliminate the exemption provided to copyrighted motion pictures. The exemption would be eliminated beginning October 1, 2005. (MCL 205.94)

The motion picture exemptions were first added to the Use Tax and General Sales Tax Acts with the enactment of Public Acts 7 and 9 of the Extra Session of 1950, which were passed unanimously by both houses of the legislature. The FY 2006 Executive Budget recommendation notes that "movie theaters or any persons leasing or purchasing a copyrighted motion picture film for public viewing is currently exempt from paying sales or use tax." The inmate purchase exemption was added to the General Sales Tax with the enactment of Public Act 207 of 1971.

House Bill 4909: Marginal Wells

The bill would increase the severance tax on marginal and stripper wells. The Severance Tax Act imposes a tax of four percent on the gross cash market value of oil severed from marginal or stripper property, those producing no more than 10 barrels (for stripper property) or 20-35 barrels (for marginal wells) of crude oil per day for 12 consecutive months. However, for other, more productive oil and gas wells, the severance tax is imposed on the gross cash market value at rate of 6.6 percent for oil and 5 percent for gas. House Bill 4909 would impose the current rate of four percent on marginal or stripper properties only through September 30, 2005. After that date, the regular rates would apply. (MCL 205.303)

The Severance Tax Act dates back to 1929 (Public Act 48) and is imposed in lieu of all other state and local taxes. The act initially imposed a tax of two percent on the gross cash market value of oil and gas severed, and made no distinction between regular and marginal property. The current rate structure was established with the enactment of Public Act 198 of 1979. Apparently, the rates were increased partly to finance the home heating income tax credit first established in 1978. The rate differential between regular and marginal wells is likely due to a desire to create an incentive to keep marginal wells in use.

The Department of Treasury's Revenue Administrative Bulletin 1992-8 notes that the lower rate for marginal property is not applicable until the property meets the qualifying definition for a period of 12 consecutive months, which is generally an average of no more than 10 barrels per day for stripper property or, depending on the well depth, no more than 20 to 35 barrels per day for marginal property. During the 12-month qualifying period, the oil and gas production is to be reported at the higher tax rate; however, at the end of the qualifying period an amended return may be filed by the taxpayer. A refund for any overpayment is then issued by the department.

House Bill 4910: Railroad Utility Property Tax Credits

House Bill 4910 would eliminate credits against the utility property tax for the maintenance and improvement of rights of way and rail rolling stock after the 2005 tax year.

Public Act 282 of 1905 imposes a property tax on public service businesses, including railroad and telephone companies, which typically maintain property spanning across several taxing jurisdictions. The tax is levied in lieu of all other state and local ad valorem taxes at a rate equal to the average statewide general ad valorem property tax rate paid by other commercial, industrial, and utility property in the preceding calendar year. For 2005, the rate is 51.68 mills.

The act provides railroad companies with a credit against the act equal to one-quarter of the amount expended for the maintenance or improvement of rights of way, although the credit cannot exceed the total tax liability. To claim the credit, the business must file a report with the State Board of Assessors identifying the location and nature of the work completed, and demonstrate that the highest priority of expenditures is given to rail lines that handle hazardous materials, particularly those located in urban or residential areas. The credit was first established with the enactment of Public Act 290 of 1977, ostensibly to encourage railroad companies to upgrade and maintain tracks in the state. The act initially had a sunset date of December 31, 1981, which was extended indefinitely with the enactment of Public Act 322 of 1980. Public Act 322 added the qualifying criteria as well.

In addition, Public Act 282 also provides a credit to railroad companies and others equal to (1) all of the expenses for the maintenance or improvement of rail rolling stock (railcars), or (2) three-quarters of the expenses incurred for the maintenance or improvement of rights of way. The credit was first established with the enactment of Public Act 341 of 2000.

House Bills 4912 and 4913: Food Sold through Vending Machines

The bills would amend the General Sales Tax Act and Use Tax Act, respectively, to eliminate exemptions from those acts for food sold through vending machines, beginning October 1, 2005. (MCL 205.54g and 205.94d)

Specifically, both acts provide that food or drink that is heated or cooled to certain temperatures – except for milk, non-alcoholic beverages in sealed containers, and fresh fruit – and sold from a vending machine is subject to the sales and use taxes. (In other words, milk, non-alcoholic beverages, fresh fruit, and other food not heated or cooled – such as snack foods – sold from a vending machine are exempt from taxation under those acts.) Beginning October 1, 2005, all food sold from a vending machine would be subject to taxation.

In the 1974 General Election, voters approved Ballot Proposal C, which amended Article IX, Section 8 of the State Constitution to exempt from sales and use taxes, the sale or use of food for human consumption, except for prepared food intended for immediate consumption, as defined by law. Public Act 310 of 1974 amended the General Sales Tax Act to incorporate the constitutional provisions into statute and define "prepared food intended for immediate consumption" to mean, among other things, food or drink intended for immediate consumption sold from a vending machine or by a vendor from a mobile facility.

Since 1974, this section of the General Sales Tax Act has been amended on numerous occasions, apparently to address the disparate treatment of food that, when sold at a grocery or convenience store, wouldn't be taxed, but when sold through a vending machine would be taxed. Public Act 275 of 1978 exempted from the sales tax the sale of milk, juices, fresh fruit, nuts, chewing gum, cookies, crackers, and chips from a vending machine. Public Act 63 of 1995 exempted bakery products sold from a vending machine from the sales tax. Public Act 576 of 1996 rewrote the vending machine provision to specify that carbonated beverages and other food or drink heated or cooled to certain temperatures – except for milk, noncarbonated beverages with a juice content of at least 10 percent juice content, and fresh fruit – are considered to be intended for immediate consumption and, as such, are subject to taxation. Public Act 417 of 2000 extended the exemption to all nonalcoholic beverages, rather than just certain noncarbonated beverages, sold through a vending machine.

Public Act 309 of 1974 exempted the purchase of food for human consumption from the use tax, although the act did not contain an exception for prepared food intended for immediate consumption. Provisions related to food from vending machines were finally added with the enactment of Public Act 172 of 2004, part of the Streamlined Sales Agreement amendments.

House Bill 4914: Water Softeners & Water Coolers

The General Property Tax Act exempts water softener equipment rented or leased for use in a residence and water coolers rented or leased for use in a residence or commercial business from personal property taxes imposed on businesses. The bill would repeal these exemptions. (MCL 211.9 and 211.9g[1])

The exemption for water softeners was added to the General Property Tax Act with the enactment of Public Act 582 of 1996, apparently at the request of companies that rent or lease out water conditioning systems to residential customers. Prior to the Public Act 582, these businesses had to report on and pay taxes in each local unit where they installed and leased or rented water conditioning systems for residential customers. It was contended that paying the taxes was an administrative burden. Additionally, it was noted that homeowners who purchased a system did not have to pay property taxes on that system.

Similarly, the exemption for water coolers was added with the enactment of Public Act 471 of 1998, because businesses that leased water coolers to residential and commercial customers had to report on and pay taxes in each local unit where it leased water coolers. Again, the personal property tax was believed to be burdensome on those businesses and an insignificant revenue source for the state and individual local units of government.

House Bills 4951 and 4953: Oil and Gas Royalty Income

The bills would essentially disallow an income tax deduction for expenses related to income that is not subject to the Income Tax Act.

Under the state Income Tax Act, the starting point for determining the tax liability for estates and trusts is federal taxable income, and the starting point for determining an individual's income tax liability is the federal adjusted gross income (AGI), both of which are then subject to various adjustments to determine state taxable income (See, generally, Michigan and IRS tax forms 1040 and 1041.) For federal taxation purposes, income levels include business income or losses, which include royalty income and related expenses from oil and gas wells. The state, however, imposes the severance tax on the gross proceeds of oil and gas "severed" from the earth in lieu of all other state and local taxes, including the income tax. [See *Bauer v. Department of Treasury* – 203 Mich App 97 (1993)]

According to the Department of Treasury's Revenue Administrative Bulletin 2001-5, for individual returns, a producer may claim a deduction for oil and gas receipts (gross income) that were subject to the severance tax, but only to the extent that the receipts were included in calculating AGI. With relevance to House Bills 4951 and 4953, oil and gas expenses can also be deducted separately on the state tax form. The administration contends that this essentially allows for a "double deduction" – that is, deducting those expenses on the federal return (to determine business income) and again on the state return, even though the income related to those expenses is not taxable under the state Income Tax Act. The legislation, the department contends, is similar to a provision in the federal Internal Revenue Code, 26 USC 265(a)(1a) that prohibits a deduction for expenses related to income that is exempt from taxation under the IRC. The Department of Treasury notes that the legislation would currently only apply to oil and gas expenses, but is written broadly enough to cover similar situations that might arise in the future.

House Bill 4951 would amend the Income Tax Act to add to federal taxable income for resident estates and trusts, expenses incurred in the production of income that is not taxable under the act, although only to the extent that those expenses were deducted in determining federal taxable income. The addition would apply to tax years that begin after December 31, 2005. (MCL 206.36)

House Bill 4953 would amend the Income Tax Act to add to federal adjusted gross for persons other than corporations, estates, or trusts, expenses incurred in the production of income that is not taxable under the act, although only to the extent that those expenses were deducted in determining federal AGI. The addition would apply to tax years that begin after December 31, 2005 (MCL 206.30)

In the past few years, state courts have issued several rulings on how oil and gas expenses and income are treated under the Severance Tax Act and the Income Tax Act. In *Elenbaas v. Department of Treasury* [231 Mich App 801 (1998) and 235 Mich App 372 (1999)] the court ruled that gross receipts, rather than net income, from the production of oil and gas may be deducted from adjusted gross income in determining state tax liability. The court noted that the severance tax is paid on the gross receipts from oil and gas production, without allowing a deduction for related expenses and stated, "[i]f gross receipts are taxed under the severance tax act, then it necessarily follows that gross receipts, not net income, are exempt from taxation under the [Income Tax Act]."

In allowing, a deduction from the Income Tax Act for oil and gas production expenses, the court stated, "[w]e also disagree with the [treasury department's] argument that allowing deductions for the expenses associated with oil and gas production amounts to allowing plaintiffs to take deductions without paying taxes on the income derived from the oil and gas ventures, which gave rise to the deductions. The Michigan severance tax is imposed on gross receipts, which include income derived from the production of oil and gas without any deductions being taken. Thus, we find it disingenuous for [the department] to argue that no tax is being paid on the income derived from the oil and gas ventures. More importantly, the fact that the gross receipts are taxed under the severance tax without an allowance for expenses under that act reinforces that the corresponding deduction for expenses should be taken under the [Income Tax Act]." [See the 1998 decision, *Elenbaas 1*.]

The court's decision in *Elenbaas 1* conflicted with a prior ruling in *Cook v. Department of Treasury* 229 Mich App 653 (1998) and, pursuant to court rules, the *Elenbaas* 1 panel was constrained to follow the *Cook* decision. But a special panel was convened to resolve the conflict between the *Elenbaas I* and *Cook* decisions. The *Elenbaas 2* panel for the most part agreed with and adopted the reasoning of *Elenbaas I* and allowed deductions from the income tax for gross receipts from oil and gas production, as well as those related expenses. However, it did not allow a net operating loss deduction resulting from those expenses.

House Bill 4952: International Telecommunications & Copyrighted Motion Pictures

Generally speaking, the Use Tax Act provides that interstate telephone communications are taxable under the act. However, the use tax is not levied against wide area telecommunications service (WATS) or a similar service, an 800 prefix service or similar service, an interstate private network and related usage charges, or an international call (inbound or outbound). The provision was added with the enactment of Public Act 326 of 1993 as part of the 1994 changes in school financing and applies only if the use tax is levied at a rate of six percent (as it currently is). The bill would repeal the exemption beginning October 1, 2005, and the communications currently exempt would be taxed in the same manner as interstate telephone communications.

Additionally, the bill provides that beginning October 1, 2005 the purchase, lease, or rental of a copyrighted motion picture film or other charges for the right to use a film would be subject to the use tax.

FISCAL IMPACT:

According to the FY 2006 Executive Budget Recommendation the bills would collectively increase state revenue for FY 2006 by approximately $112 million, of which $64 million is General Fund/General Purpose revenue and $48 million is School Aid Fund revenue. The following table lists the fiscal impact, based on figures provided by the Department of Treasury, of each change.

	Fiscal Impact (Millions of Dollars)	
	GF/GP	SAF
House Bills 4905 – 4907 (Interstate Trucks and Trailers Rolling Stock): Purchases of trucks, trailers, and parts by interstate motor companies are exempt from sales taxes as long as at least 10% of the company's total mileage driven occurs outside of Michigan. House Bill 4905 would eliminate the sales tax exemption, and House Bill 4906 would eliminate the use tax exemption. House Bill 4907 would provide a credit against sales and use taxes paid, so that rolling stock would essentially be taxed in proportion to its use in Michigan. The bill would increase sale and use tax revenue by an estimated $16.4 million.	$5.6	$10.8
House Bills 4908, 4911, and 4952 (Copyrighted Motion Pictures): Copyrighted motion pictures that are purchased or leased for public viewing by either theaters or individuals are exempt from sales and use taxes. House Bill 4908 would eliminate the sales tax exemption, and House Bill 4911 would eliminate the use tax exemption. House Bill 4952 would subject the purchase, lease, or rental to the use tax. Taxing this activity would increase sales tax revenue by about $6.8 million and use tax revenue by about $13.2 million.	10.7	9.3
House Bill 4908 (Purchases Made by Department of Corrections Inmates): Eliminating the sales tax exemption for prison inmates would increase sales tax revenue by an estimated $0.7 million.	0.2	0.5
House Bill 4909 (Marginal Wells): Natural gas producers pay a 5.0% severance tax rate on the gross cash value of their production; oil producers pay a 6.6% tax rate. Marginal wells that produce lesser amounts (typically about 35 or fewer barrels of oil per day) are taxed at a reduced rate of 4.0%. Increasing the tax rate on marginal wells to the regular rate would increase the severance tax by an estimated $2.2 million.	2.2	0.0
House Bill 4910 (Railroad Utility Property Tax Credit): Railroad companies that maintain or improve railroad cars and/or rights-of-way are eligible for a credit against the state utility property tax. Eliminating these credits would increase the utility property tax by an estimated $20 million.	20.0	0.0
House Bills 4912 and 4913 (Food Sold Through Vending Machines): Most food sold for immediate consumption is subject to sales taxes. Hot or cold foods dispensed from vending machines are also subject to the sales tax, although some foods sold through vending machines are specifically exempt. The bills would eliminate the sales and use tax exemptions for most foods sold through vending machines. This would increase sales tax revenue by an estimated $25.2 million	6.7	18.5
House Bill 4914 (Water Softener and Water Coolers): Currently, water coolers and water softeners that are leased are exempt from the personal property tax. Eliminating this exemption would subject this property to the 6-mill State Education Tax (SET) as well as the 18-mill non-homestead millage. The 6-mill SET would directly increase the SAF; the 18-mill non-homestead millage would be dedicated to pupil funding at the local level.	0.0	0.5
House Bills 4951 and 4953 (Oil and Gas Royalty Income): The bills would essentially disallow an income tax deduction for expenses related to income that is not subject to the Income Tax Act. Eliminating this deduction would increase income tax revenue by an estimated $5.0 million.	4.0	1.0
House Bill 4952 (International and Certain Interstate Communications): International and certain interstate telecommunications are currently exempt from the use tax. Making such telecommunications subject to the use tax would increase revenue by about $22.0 million.	14.6	7.3
TOTAL	**$64.0**	**$47.9**

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.