

Legislative Analysis



GOVERNOR'S TAX PROPOSAL

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House Bills 4361 & 4362

Sponsor: Rep. Jud Gilbert, II

Committee: Tax Policy

Complete to 4-15-11

A REVISED SUMMARY OF HOUSE BILLS 4361 & 4362 AS INTRODUCED 3-1-11

BRIEF SUMMARY: House Bill 4361 would amend the Income Tax Act to implement Governor Snyder's Executive Recommendation for tax changes. The bill divides the Income Tax Act into two parts: Part One contains provisions for the individual or personal income tax act, and Part Two, which is entirely new, contains provisions for the corporate income tax. House Bill 4362 would amend the Michigan Business Tax Act so that MBT credits awarded through 2011 could stay in place through the life of the agreements.

These tax changes consist of:

- Eliminating the Michigan Business Tax (MBT). Under House Bill 4362, the act would be repealed when the last credit or carryforward based on a credit was claimed. Taxpayers could choose to continue to file under the MBT to keep certain "certificated credits."
- Imposing a new 6% corporate income or profits tax with no credits, except for the small business credit. This would apply to C corporations only, and would be effective January 1, 2012.
- Eliminating various income tax expenditures – including the pension exemption (both public and private pensions) and the earned income tax credit (EITC) for low-income workers. These two have the largest fiscal impact. For the complete list, see the description beginning on Page 4, and the table on Page 7. Elimination of the pension exemption means that pensions would be subject to income tax (although not Social Security payments).
- Freezing the income tax rate at 4.25%. (Under current law, the income tax rate is 4.35%. Beginning October 1, 2011, the rate is scheduled to be reduced by 0.1 percentage points each year until the rate reaches 3.95%; then the rate is scheduled to be reduced to 3.9% effective October 1, 2015. Under the proposal, these reductions would not take place.)

FISCAL IMPACT: In total, these tax changes would reduce revenue by an estimated \$270.6 million in FY 2011-12 and decrease revenue by \$64.0 million in FY 2012-13.

However, these tax changes would *increase* General Fund/General Purpose (GF/GP) revenue by an estimated \$326.5 million in FY 2011-12 and \$466.3 million in FY 2012-13 while *reducing* reduce School Aid Fund (SAF) revenue by an estimated \$597.1 million in FY 2011-12 and \$530.3 million in FY 2012-13.

Table 1, below, includes the estimated fiscal impact of the Executive Recommendation for tax changes, which would be effective January 1, 2012. A more detailed chart is found on Page 8.

Table 1
Potential Tax Changes under the Executive Recommendation (Summary)
Effective Date January 1, 2012
(Millions of Dollars)

<u>Business Tax Related</u>	<u>FY 2011-12</u> <u>Estimates</u>	<u>FY 2012-13</u> <u>Estimates</u>
Repeal MBT	(\$2,170.0)	(\$2,024.4)
Partial Year MBT	900.2	0.0
6% Corporate Income Tax (Only C Corps)	460.1	748.8
Financial Institutions Tax	27.7	43.9
Honor Existing Firm-Specific Credits	<u>(293.0)</u>	<u>(500.0)</u>
Net Business Tax Change	(1,075.0)	(1,731.7)
<u>Income Tax Related</u>		
Individual Income Tax Changes	804.4	1,838.7
Tax and Fee Reform Reserve Fund	<u>0.0</u>	<u>(171.0)</u>
Net Income Tax Change	804.4	1,667.7
Total Tax Changes	(270.6)	(64.0)
GF/GP	326.5	466.3
SAF	(597.1)	(530.3)

DETAILED SUMMARY:

MBT and Corporate Income Tax Changes

The Executive Recommendation would repeal the Michigan Business Tax and replace it with a 6% corporate income or profits tax with no credits, except for the small business credit. Qualified small businesses are eligible to pay an alternate tax equal to 1.8% of adjusted business income. The business tax on insurance companies and financial institutions would not be fundamentally changed from current law. Unlike the MBT, the corporate income tax would apply only to C corporations and not other business types. Credits that have already been awarded under the MBT, such as MEGA, brownfield redevelopment, renaissance zone, film production, battery/photovoltaic, and other credits would be retained for the duration of the agreements, but no additional credits would be awarded after 2011.

Businesses that are not C corporations would pay taxes only through the individual income tax, but the apportionment formula that individuals affiliated with multi-state firms would use for determining business income would be based solely on a sales factor rather than equally on sales, property, and payroll.

Combined, the MBT and corporate income tax changes proposed in the Executive Recommendation would reduce business taxes by an estimated \$1.08 billion in FY 2011-12 and \$1.73 billion, which is an 86% reduction, on a full year basis in FY 2012-13.

As a background, the MBT is a tax on all businesses with apportioned gross receipts above \$350,000 with business activity in Michigan. The MBT has two main components to its tax base: (1) business income or net profit and (2) modified gross receipts (gross receipts less purchases from other firms, such as inventory, depreciable assets, and materials and supplies). Business income is taxed at 4.95% and modified gross receipts component is taxed at 0.8%.

In addition, the MBT includes many credits and a surcharge. The surcharge (except for insurance companies and financial institutions) is 21.99% of taxpayer's MBT liability after apportionment but before credits and is limited to \$6 million per taxpayer per tax year. For financial institutions, the MBT surcharge is 23.4%, but insurance companies are not subject to the surcharge.

The MBT was originally designed to be revenue neutral with the SBT and a personal property tax (PPT) cut and to reimburse the SAF for the state and local PPT exemptions, which totaled \$479 million in FY 2008-09. The PPT is primarily a local tax levied on businesses for personal property such as equipment, machinery, furniture, and fixtures. The MBT property tax related legislation exempted industrial personal property from the 6 mill state education tax, the industrial facilities tax portion of the 18 school operating mills, and the 18 school operating mills. It also exempted commercial personal property from up to 12 of the school operating mills.

As noted earlier, credits that have already been awarded under the MBT, such as MEGA, brownfield redevelopment, renaissance zone, film production, battery/photovoltaic, and other credits would be retained for the duration of the agreements, but no additional credits would be awarded.

A brief description of the temporarily retained credits follows.

- MEGA. Numerous credits for new or expanding firms based on additional payroll and health care costs or additional business activity costs associated with an expansion or new location.
- Brownfield Redevelopment. Credit for some of the costs of demolition, construction, restoration, or alteration of buildings located in Brownfield development zones.

- Renaissance Zone. Credit against the MBT for businesses located within one of the more than 150 renaissance zone boundaries.
- Film Production Credits. Credits for film production expenditures: 40 - 42% refundable credit for direct production expenditures (including, but not limited to, compensation payments to producers, directors, writers, and actors), 30% credit for qualified personnel expenditures (below the line personnel, such as technical crew, who were not residents of Michigan for at least 60 days before approval of the agreement), 25% investment film infrastructure credit, and a 50% qualified job training credit.
- Battery Credits. A variety of credits are issued for battery related activity: pack engineering, integration and assembly credits, vehicle engineering credit, advanced battery technologies credit, and battery cell manufacturing credits.
- Other Credits. Historic, farmland, and workers disability credits. The historic preservation credit provides a credit up to 25% of expenditures for the restoration of a qualified historic site. The farmland preservation credit provides property tax relief for corporate farms. The workers' disability supplemental benefit credit provides for 100% of the supplemental cost of living payments made to persons injured between September 1965 and December 1979.

Personal Income Tax Changes

The income tax changes proposed by the Governor would increase the income tax by an estimated \$804.4 million in FY 2011-12 and \$1.67 billion in FY 2012-13. The proposed changes are as follows.

- Freeze income the tax rate at 4.25%. Under current law, the income tax rate is 4.35%. Beginning October 1, 2011, the rate is scheduled to be reduced by 0.1 percentage points each year until the rate reaches 3.95%; then the rate is scheduled to be reduced to 3.9% effective October 1, 2015.
- Eliminate pension exemption. Under current law, Social Security, military, federal, state and local government pension/retirement income is fully exempt. Private pensions are exempt up to \$45,120 single/\$90,240 joint (TY 2010) – these levels are indexed to inflation. In Michigan, defined benefit plans, IRAs, and annuities are fully exempt. Also, 401(k) distributions attributable to employer contributions or to employee contributions that are matched by the employer are exempt, but distributions attributable to employee contributions that are not matched by the employer are currently subject to the state income tax, subject to the private pension limits. In addition, 401(k)s with no employer match are not considered pensions and therefore are completely subject to the income tax. The Executive Recommendation would eliminate these exemptions (except for the military and Social Security exemptions).

- Eliminate the dividends, interest, capital gains exemption received by seniors. Under current law, senior investment income up to \$10,058 single/\$20,115 joint (TY 2010, indexed to inflation) is exempt.
- Eliminate the \$2,300 (TY 2010, indexed to inflation) special exemptions for seniors and individuals with unemployment compensation equal to or greater than 50% of their AGI (adjusted gross income, Michigan's starting point from federal return).
- Personal exemption phase-out. Under current law, \$3,700 (TY 2011, indexed to inflation) is exempt from AGI for each personal exemption claimed on the federal income tax return. The personal exemption increases in \$100 increments based on inflation. The Executive Recommendation would phase-out the personal exemption for single taxpayers between the income range of \$75,000 and \$100,000 and for married taxpayers between the income range of \$150,000 and \$200,000. Taxpayers with incomes above the upper bound would receive no personal exemption. The formula for the phasing out of the exemption is:

$$\text{Personal Exemption multiplied by: } \frac{\$100,000 \text{ minus total household resources}}{\$25,000}$$

- Eliminate child deduction. The child deduction provides a \$600 subtraction from AGI for each dependent child age 18 or younger.
- Eliminate miscellaneous subtractions. The Executive Recommendation would eliminate subtractions for political contributions; prizes won from bingo, raffle, or charity games; losses from the disposal of property; income from gas and oil royalty interest; certain distributions from IRAs used to pay higher education expenses; qualifying distributions from a pension or retirement plan that is contributed to a charitable organization.
- Eliminate the city income tax credit. The city income tax credit is a non-refundable credit to partially offset the city income tax liability (levied in 22 cities). In TY 2008, 823,600 credits were allowed, and the average credit was \$38.
- Eliminate the public contributions credit. The public contributions credit is a non-refundable credit equal to 50% of the amount contributed up to a maximum credit of \$100 for single (\$200 for joint) returns. Public contributions include gifts to Michigan colleges and universities, public libraries, museums, and public broadcasting stations. In TY 2008, 273,300 credits were allowed, and the average credit was \$90.
- Eliminate the community foundations credit. The community foundations credit is a non-refundable credit equal to 50% of the amount contributed up to a

maximum credit of \$100 for single (\$200 for joint) returns. In TY 2008, 35,200 credits were allowed, and the average credit was \$93.

- Eliminate the homeless shelter/food bank credit. The homeless shelter/food bank credit is a non-refundable credit equal to 50% of the amount contributed up to a maximum credit of \$100 for single (\$200 for joint) returns. The credit is for cash donations to qualifying homeless shelters, food banks, and food kitchens whose primary purpose is to provide accommodations or food to indigent persons. In TY 2008, 234,100 credits were allowed, and the average credit was \$81.
- Eliminate the historic preservation credit. The historic preservation credit is a refundable and a non-refundable credit to rehabilitate historic sites and is equal to 25% of the qualified expenditures. In TY 2008, about 300 credits were allowed and the average credit was \$4,581.
- Eliminate the college tuition and fees credit. The college tuition and fees credit is a non-refundable credit for resident taxpayers with AGIs of less than \$200,000 and is equal to a percentage of tuition and fees. To qualify, the school must have certified that tuition and fees will not increase by more than the rate of inflation. The amount of the credit is the lesser of 8% of the tuition and fees paid or \$375 per student. The credit cannot be claimed for more than 4 years for any one student. In TY 2008, about 83,000 credits were allowed and the average credit was \$146.
- Eliminate the vehicle donation credit. The vehicle donation credit is a non-refundable credit to equal to 50% of the fair market value of certain automobile donations to qualified charitable organizations. The credit is limited to up to a maximum credit of \$100 for single (\$200 for joint) returns. In TY 2008, about 2,200 credits were allowed and the average credit was \$56.
- Eliminate the individual or family development credit. Individuals or families whose income is 200% of the federal poverty level can establish accounts for qualified expenses and receive a nonrefundable credit equal to 75% of the contributions made to the account.
- Eliminate the adoption credit. The adoption credit provides refundable credit of up to \$1,200 per child, to the extent that qualified adoption expenses exceed the amount allowed under the federal adoption credit. In TY 2008, about 600 credits were allowed, and the average credit was \$1,241.
- Eliminate the stillbirth credit. This refundable credit is available to taxpayers who have been provided with a Certificate of Stillbirth. The credit is equal to 4.5% of the personal exemption amount, rounded to the closest \$10 increment.
- Eliminate the earned income tax credit. The EITC is a refundable credit for working low income households equal to 20% of the federal EITC. The federal

credit is equal to a percentage of the taxpayer's earned income based on the number of children in the household, up to a certain amount adjusted annually for inflation. In TY 2008, the maximum federal credit was \$438 for taxpayers with no children; \$2,917 for taxpayers with one child; and \$4,824 for taxpayers with more than one child. Based on our sample of TY2009 state income tax data, there were 782,671 claimants and the total amount claimed was \$336.7 million. The average credit was \$430.20. Of the total claimants, 551,126 were from households with children under the age of 19. These claims totaled \$308.4 million, which is an average of \$559.50 per claim. This represents 70.4% of the total number of claims and 91.6% of the total dollar amount of claims. The remaining 231,545 claims were from households without children which totaled \$28.4 million, or \$122.46 per claim.

Elimination of the EITC would increase revenue by an estimated \$373.7 million for FY 2012-13. In recent years, a portion of the state earned income tax credit has been used to meet maintenance of effort (MOE) requirements for federal Temporary Assistance for Needy Families (TANF) dollars. Elimination of the credit would also eliminate this TANF MOE claim generated by the state EITC. Thus, other eligible state spending would need to be identified to ensure that MOE requirements were met.

- Homestead property tax credit (HSPTC) changes. For TY 2008, Michigan taxpayers with household income less than \$82,650 may claim a property tax credit, and the computed credit is reduced by 10% for every \$1,000 that household income exceeds \$73,650. Under current law, the credit is equal to 60% of the amount by which property taxes (or 20% of rent for renters) exceed 3.5% of household income, up to a maximum of \$1,200. For seniors and disabled filers, the credit is equal to 100% of the difference. The proposed changes would adjust the percentage by which property taxes exceed 3.5% of household income to 80% for all filers except disabled taxpayers, who remain at 100%. In addition, the credit would phase out between the income level of \$60,000 and \$70,000. Taxpayers that currently take the HSPTC with household income between \$70,000 and \$82,650 (roughly 78,600 filers) would not be able to take the credit under the Governor's plan.

In TY 2008, about 453,200 senior credits were allowed and the average credit was \$770. Also, 1,058,500 general credits were allowed and the average credit was \$498.

- Reserve for future tax and fee reform. The Executive Recommendation would set aside a portion of income tax revenue in a Tax and Fee Reform Reserve Fund; the Executive budget has indicated that this is to be used for future tax cuts. This amount would total an estimated \$171 million in FY 2012-13, \$380 million in FY 2013-14, \$593 million in FY 2014-15, and \$719 million in FY 2015-16.

Table 2
Potential Tax Changes under the Executive Recommendation in Detail
Effective January 1, 2012
(Millions of Dollars)

	FY 2011-12 Estimates			FY 2012-13 Estimates		
	GF/GP	SAF	Total	GF/GP	SAF	Total
<u>Business Tax Related</u>						
Repeal MBT	(1,419.8)	(750.2)	(2,170.0)	(1,260.7)	(763.7)	(2,024.4)
Partial Year MBT	900.2	0.0	900.2	0.0	0.0	0.0
6% Corporate Income Tax (Only C Corps)	460.1	0.0	460.1	748.8	0.0	748.8
Financial Institutions Tax	27.7	0.0	27.7	43.9	0.0	43.9
Honor Existing Firm-Specific Credits	(293.0)	0.0	(293.0)	(500.0)	0.0	(500.0)
Net Business Tax Change	(324.8)	(750.2)	(1,075.0)	(968.0)	(763.7)	(1,731.7)
<u>Income Tax Related</u>						
Freeze Income Tax Rate at 4.25%	0.0	0.0	0.0	171.0	0.0	171.0
Eliminate Private Pension Exemption	363.5	95.4	459.0	553.0	146.5	699.5
Eliminate Public Pension Exemption	121.6	31.3	153.0	184.4	48.8	233.2
Retain Military Pension Exemption	(12.3)	(3.2)	(15.4)	(19.8)	(3.7)	(23.5)
Eliminate Investment Income Exemption By Seniors	28.1	7.2	35.4	42.9	11.0	53.9
Eliminate Some Special Exemptions	6.7	2.1	8.8	40.9	0.0	40.9
Phase-Out Personal Exemption	41.4	13.0	54.4	63.2	19.7	82.9
Eliminate Child Deduction	0.0	0.0	0.0	57.0	0.0	57.0
Eliminate Miscellaneous Subtractions	28.1	7.2	35.4	42.9	11.0	53.9
<u>Eliminate Non-refundable Credits</u>						
City Income Tax Credit	26.3	0.0	26.3	36.7	0.0	36.7
Public Contributions Credit	20.3	0.0	20.3	28.1	0.0	28.1
Community Foundations Credit	3.0	0.0	3.0	4.1	0.0	4.1
Homeless Shelter/Food Bank Credit	16.5	0.0	16.5	22.8	0.0	22.8
Historic Preservation Credit	0.0	0.0	0.0	0.0	0.0	0.0
College Tuition Credit	7.1	0.0	7.1	9.8	0.0	9.8
Vehicle Donation Credit	0.8	0.0	0.8	1.0	0.0	1.0
Individual or Family Development Credit	0.0	0.0	0.0	0.0	0.0	0.0
<u>Eliminate Refundable Credits</u>						
Adoption Credit	0.0	0.0	0.0	1.0	0.0	1.0
Stillbirth Credit	0.0	0.0	0.0	0.0	0.0	0.0
Eliminate EITC	0.0	0.0	0.0	373.7	0.0	373.7
Changes to Homestead Property Tax Credits	0.0	0.0	0.0	(7.2)	0.0	(7.2)
Tax and Fee Reform Reserve Fund	0.0	0.0	0.0	(171.0)	0.0	(171.0)
Net Income Tax Change	651.2	153.1	804.4	1,434.4	233.4	1,667.8
Total Tax Changes	326.5	(597.1)	(270.6)	466.3	(530.3)	(64.0)

Source: Michigan Department of Treasury & House Fiscal Agency

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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.