Issue Paper

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FACING THE MICHIGAN LEGISLATURE

Senate Fiscal Agency

BUSINESS TAXES IN MICHIGAN
YESTERDAY, TODAY, AND TOMORROW

by

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Taxes Paid by Businesses in Michigan

- While the single business tax is the most visible tax paid by businesses in Michigan, the $1.9 billion it generated in fiscal year (FY) 2004-05 accounted for only 13.0% of the estimated $13.7 billion that was paid by businesses in total State and local government taxes.
- In addition to the single business, personal property, and unemployment insurance taxes, which are general business taxes, businesses in Michigan pay specific business taxes and general taxes.
- In FY 2004-05, general taxes accounted for 60.0% of total business tax payments, while general business taxes accounted for 34.0% and specific business taxes accounted for 6.0%.

Single Business Tax: Michigan's Major Business Tax

- Michigan adopted the single business tax (SBT) in 1975.
- It replaced eight other business taxes including the state government corporate income and franchise taxes, and a local property tax on business inventories.
- The SBT was adopted to create a more stable source of revenue, help stimulate capital investment and create new jobs, and help eliminate a budget deficit.
- The SBT is a tax on the amount of value a business adds to its output.
- Under the SBT, value added is calculated by summing the items that add value to a product, including compensation paid to workers and profits.
- The SBT is assessed on all forms of business including C corporations, S corporations, partnerships, and sole proprietorships.
- In 2001, 45.0% of Michigan's businesses did not owe any SBT, 42.0% of the firms paid 10.0% of the total liability, and 13.0% of the businesses paid 90.0% of the tax.
- Single business tax revenue totaled $1.9 billion in FY 2004-05, which was down almost 20.0% from its peak level of $2.36 billion in FY 1998-99.
- The SBT rate was gradually reduced from 2.3% in 1998 to 1.9% by 2002.
- The SBT is scheduled to be repealed effective December 31, 2007.

Michigan's Taxes on Personal Property

- While both individuals and businesses pay tax on their real property, only businesses pay tax on their personal property.
- Business personal property includes such items as machinery, equipment, office furniture, computers, and vehicles.
- Business personal property is subject to several taxes on property, including the local general property and industrial facilities taxes and the State education and utility property taxes.
- Of the $1.8 billion that businesses paid in personal property taxes in 2005, $1.4 billion went to local governments and $0.4 billion went to State government.

Michigan's Business Tax Burden

- State and local taxes paid by business as a percentage of total business activity, as measured by Gross State Product, declined from 5.1% in FY 1984-85 to 4.0% in FY 2004-05.
- The share of total State and local taxes paid by business fell from 44.2% in FY 1984-85 to 37.9% in FY 2004-05.
- Michigan's business tax burden was the 36th lowest among the 50 states in FY 2004-05.

How Other States Tax Businesses

- 43 states have a corporate income tax.
- Of the states with a corporate income tax, 11 have a minimum tax, five require a business to pay the greater of a franchise tax or corporate income tax, and 15 states extend their tax to S corporations and/or partnerships in addition to regular corporations.
- 16 states assess a franchise or net worth tax in addition to a corporate income tax.
- 14 states levy a property tax on business inventories.
- 39 states assess a property tax on at least some business personal property.
- Other than Michigan, only one state (New Hampshire) levies a value-added tax and it is levied in addition to the state's corporate income tax.
- 5 states levy some other type of tax as their major business tax.
- Ohio is phasing in a gross receipts tax to replace its corporate franchise (income) tax.
- Texas just replaced its franchise tax with a so-called "margin" tax whose base is primarily profit or business income.

Key Principles for Evaluating Alternative Business Taxes

- Reliability - A tax should provide a stable stream of revenue and a sufficient amount of revenue to support a state's desired spending level.
- Equity - A tax should have "horizontal" equity (similar businesses should be taxed similar amounts) and "vertical" equity (the tax burden should be distributed fairly among different types and sizes of businesses).
- Efficiency - A tax should be simple enough that administrative costs, taxpayer compliance costs, and economic distortion costs are kept to a minimum.
- No Perfect Tax - Each tax has its strengths and weaknesses regarding reliability, equity, and efficiency. For example, a very simple tax will probably not be very equitable.

Alternative Business Tax Structures

- Corporate Income Tax. This is a tax based on a corporation's business income or profit. Most states use the definition of business income adopted by the Federal corporate income tax as their starting point. The corporate income tax is a widely used tax among the states, but its revenue stream is very volatile and it is a tax on capital.
- Business Income Tax. This tax is similar to the corporate income tax, but in addition to corporations it includes other legal forms of business such as partnerships and S corporations. Because this tax has a broader base than the corporate income tax has, its tax rate can be lower and its revenue stream is more stable. It is also a tax on capital.
- Gross Receipts Tax. This is a tax on a business's total sales. The base of this tax is much broader than the base of an income tax, so the tax rate needed to generate a given amount of revenue is much lower. A gross receipts tax provides a fairly stable revenue stream and can be relatively simple to administer and comply with; however, an inherent problem is tax pyramiding, which creates unequal tax burdens among similar businesses.
- Business License Tax. This tax ranges from a flat dollar amount per taxpayer to a tax with several brackets based on sales or income; each bracket has its own fixed tax amount. The biggest advantage of this tax is that it is very simple and provides a very stable source of revenue. Its disadvantages depend on which base is used, but they frequently include limited annual revenue growth and inequitable tax burdens among businesses.
- Franchise Tax. This is typically a tax on a business' net worth, assets, or stock. It provides a fairly stable source of revenue, but the tax must be paid even if no profit is realized.

- Restructured Value-Added Tax. This option involves restructuring and simplifying the current single business tax. Some of the existing deductions, exemptions, and credits could be eliminated and the base could be calculated using a subtractive method instead of the current additive method. A value-added tax helps minimize economic costs because of neutrality with respect to labor and capital and its revenue stream is more stable than that of an income tax.
- "Fair Tax". In the context of business tax reform, the fair tax tends to involve much broader changes in the overall tax structure than the other major alternative business taxes involve. The fair tax is a broad-based retail consumption tax that includes all goods and services. Instead of having a low rate, however, this tax would have a relatively high rate in order to generate sufficient revenue to replace not only the single business tax, but other major taxes as well, including the income and State education property taxes. To help offset the regressive nature of a broad-based consumption tax, the fair tax would provide government payments to low-income individuals. This tax would tend to be a relatively stable source of revenue, but it would shift the tax burden more toward individuals and away from businesses and also would raise some other tax equity issues.

INTRODUCTION

At the present time, much attention is being focused on business taxes in Michigan. Under current law, Michigan's SBT Act is scheduled to be repealed effective for tax years beginning after December 31, 2007. A special joint Senate/House committee has been established to study alternative business tax options and recommend the best way to replace some or all of the revenue currently being generated by the SBT. This special joint committee has broadened its focus to include exploring the possibility of replacing the personal property tax.

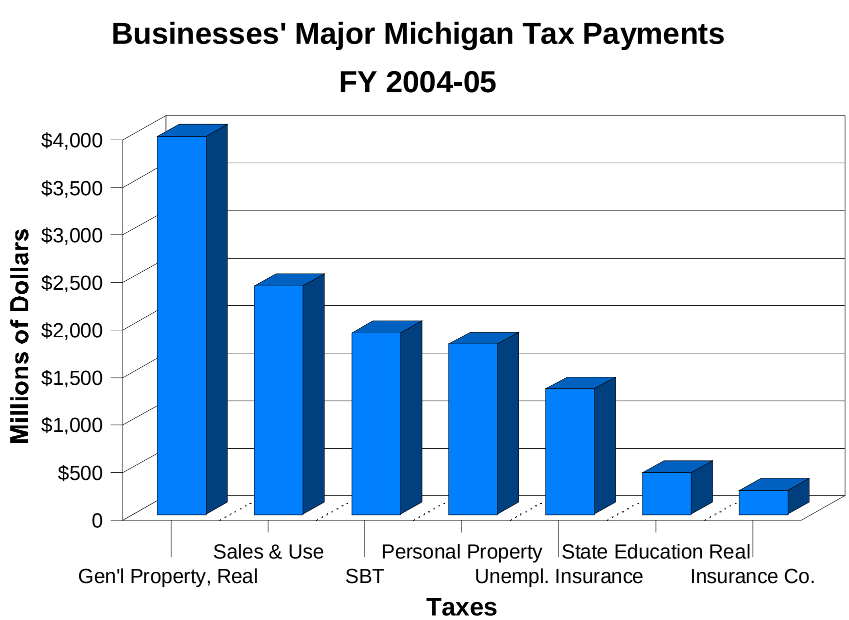
This Senate Fiscal Agency report is designed to provide background information on a variety of topics related to business taxes, including:

- Taxes currently paid by businesses in Michigan,
- Some history and description of the single business and personal property taxes,
- Michigan's business tax burden compared with that of other states,
- The taxes other states assess on businesses,
- Key economic principles used for evaluating alternative tax structures,
- The pros and cons of various alternative business taxes, and
- A summary of proposals made so far by various groups to restructure Michigan's key business tax.

TAXES PAID BY BUSINESSES IN MICHIGAN

When "businesses" and "taxes" are mentioned together in Michigan, most people think of the SBT, which generated $1.9 billion in FY 2004-05; however, taxes paid by businesses in Michigan go far beyond this tax. In FY 2004-05, businesses directly paid an estimated $13.7 billion in taxes to Michigan's State and local governments. Table 1 provides an overview of the taxes paid by businesses in Michigan and it breaks them down into three broad categories: 1) general business taxes, 2) specific business taxes, and 3) general taxes. Figure 1 presents the major business tax payments in FY 2004-05.

Figure 1



Source: Senate Fiscal Agency

General Business Taxes. A general business tax is a tax designed to be assessed on businesses regardless of their type of business. There are three taxes that fall under this category in Michigan – the SBT, the personal property tax, and the unemployment insurance tax. The SBT is the most widely recognized tax on business in Michigan (and is described in further detail in the next section of this report). While there is no tax called the "personal property tax", several taxes including the general property tax and the State education tax are assessed in part on business personal property. Most of the revenue collected on personal property is derived from the general property tax, a local government tax. The unemployment insurance tax is assessed on businesses to help fund the unemployment insurance program. As shown in Table 1, these general business taxes accounted for about 34.0% of total State and local taxes paid by businesses in FY 2004-05.

Specific Business Taxes. In addition to the general business taxes, Michigan assesses some special taxes on particular sectors of the business community. Taxes falling in this category include the casino gaming tax, horse race wagering tax, insurance company tax, oil and gas severance tax, and utility property tax. These special business taxes accounted for 5.9% of total State and local taxes paid by businesses in FY 2004-05.

Table 1

MICHIGAN'S STATE AND LOCAL TAXES PAID BY BUSINESSES				
Taxes	**FY 2004-05 Revenue (Millions $)**	**Percent of Total Revenue**	**Year Adopted**	**Base of Tax**
General Business Taxes[1]				
Single Business	$1,907.2	14.0%	1975	Compensation, profits, gross receipts
Unemployment Insurance	1,404.3	10.3	1936	Covered wages paid up to $9,500/employee
Personal Property, General and SET Property Taxes[2]	1,489.4	10.9	1893	Most equipment, furniture, and fixtures used by businesses
Subtotal	**$4,800.9**	**35.1%**		
Specific Business Taxes[3]				
Casino Gaming	$145.8	1.1%	1996	Adjusted gross receipts from gaming
Commercial Forest	3.1	0.0	1925	Land placed in a commercial forest reserve program, tax per acre
Horse Race Wagering	10.9	0.1	1933	Amount wagered
Industrial Facilities	227.2	1.7	1974	In lieu of general property tax, tax only on property prior to improvements
Insurance Company	249.5	1.8	1869	Gross premiums sold
Severance, Oil and Gas	68.1	0.5	1929	Value of oil and natural gas at the wellhead
Utility Property	99.1	0.7	1905	Taxable value of telephone, railroad, & railroad car company property.
Subtotal	**$803.7**	**5.9%**		
General/Other Taxes Paid by Businesses[4]				
Diesel Fuel	$139.4	1.0%	1947	Diesel fuel consumed or purchased in Michigan
Gasoline	196.0	1.4	1925	Gasoline purchased in Michigan
General Property Tax, Real Property	4,145.0	30.3	1893	Taxable value of real property, includes local school 18-mill tax
Income (State)	164.3	1.2	1967	Income received by individuals including pass-through business income.
Income (Cities)	165.0	1.2	1964	Corporate income, net profits.
Motor Vehicle Registration	296.6	2.2	1905	Weight or sale price of vehicle
Real Estate Transfer Tax	78.4	0.6	1993	Fair market value of real property when it changes ownership
Sales	1,979.7	14.5	1933	Business purchases excluding goods used directly in industrial processing.
State Education Property, Real Property	433.8	3.2	1993	Taxable value of property
Use	420.7	3.1	1937	Business purchases excluding goods used directly in industrial processing.
Other	43.4	0.3		
Subtotal	**$8,062.3**	**59.0%**		
Total State and Local Taxes Paid by Business	**$13,666.9**	**100.0%**		

[1] Taxes assessed on businesses in general. [2] Total taxes on business personal property are estimated at $1.8 billion. Business personal property is taxed under the general property tax, State education property tax, industrial facilities tax, and utility property tax. [3] Taxes assessed on specific types of businesses. [4] General taxes assessed on both businesses and individuals. Dollar amounts are estimated portions of each particular tax paid by businesses.

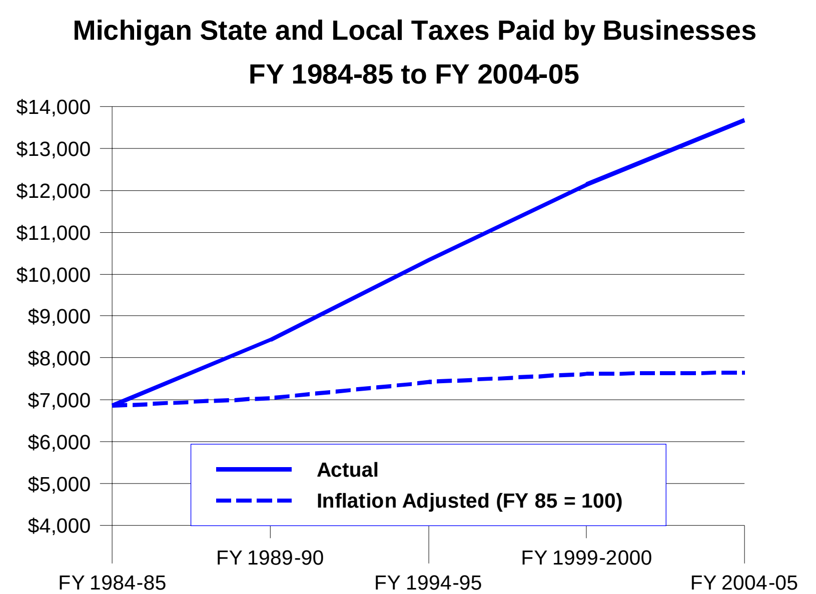
Source: Senate Fiscal Agency

General Taxes Paid by Businesses. In addition to the taxes paid only by businesses, businesses pay some of the general taxes assessed by Michigan's State and local governments. Some of the general taxes that are paid in part by businesses are the general property tax on real property, sales and use taxes, motor fuel taxes, vehicle registration tax, and State education property tax. Each of these taxes is assessed on both individuals and businesses. For example, Michigan assesses a sales tax on most retail purchases of tangible goods, including items purchased by businesses. When a business purchases items that are to be used by the business and not resold, such as office furniture or office supplies, it must pay sales tax. Similarly, businesses must pay property taxes on their real property, just as individuals must pay property taxes on their homes. It is estimated that these general taxes accounted for about 60.0% of the total amount of taxes paid by businesses to State and local governments in Michigan in FY 2004-05. In fact, it is estimated that the largest tax liabilities businesses incur in Michigan are not from the SBT or taxes on personal property, but are the general property tax on real property and the general sales and use taxes, as shown in Figure 1.

Business Tax Collections from FY 1984-85 to FY 2004-05

Table 2 and Figure 2 provide estimates of the State and local taxes paid by businesses in Michigan from FY 1984-85 to FY 2004-05. During this 20-year period, the amount businesses paid in State and local taxes doubled from $6.87 billion in FY 1984-85 to $13.67 billion in FY 2004-05. During this period of time, the revenue generated from State taxes paid by businesses generally grew at a slower rate than the revenue from local taxes, due to the fact that property taxes tended to grow at a faster rate than other business taxes and local government taxes are dominated by the general property tax. The major exception to this trend occurred in FY 1994-95, when the enactment of Proposal A, a major school finance reform measure, reduced local school property taxes and increased the State's sales and use taxes, as well as created the new State education property tax. This shift from local taxes to State taxes caused State taxes paid by businesses to increase 46.7% from FY 1989-90 to FY 1994-95, while the taxes paid by business to local governments fell 5.3% during this time period.

Figure 2



Source: Senate Fiscal Agency

Table 2

MICHIGAN STATE AND LOCAL TAXES PAID BY BUSINESSES SELECTED YEARS: FY 1985 - FY 2005 (Millions of Dollars)					
Taxes by Type	**FY 1984-85**	**FY 1989-90**	**FY 1994-95**	**FY 1999-2000**	**FY 2004-05**
State Government Taxes Paid by Business:					
Single Business	$1,378.4	$1,798.6	$2,130.4	$2,324.9	$1,907.2
Insurance	117.0	78.6	213.6	191.9	249.5
Sales & Use	745.2	943.6	1,748.1	2,289.9	2,400.5
Utility Property (real & personal)	62.7	142.3	127.2	149.2	99.1
Transportation Related	263.4	343.8	410.8	638.0	632.0
Unemployment Compensation	1,284.4	1,050.9	1,389.7	1,017.8	1,404.3
State Education Property (real & personal)	0.0	0.0	404.2	508.9	606.5
Other	178.6	187.4	242.9	442.8	634.9
Subtotal State Taxes	$4,029.8	$4,545.1	$6,666.9	$7,563.4	$7,933.9
% Change	---	12.8%	46.7%	13.4%	4.9%
Local Government Taxes Paid by Business:					
Property Taxes (real & personal)	$2,711.3	$3,757.8	$3,535.7	$4,386.6	$5,553.9
Income & Utility Taxes	125.4	132.9	150.0	180.8	179.0
Subtotal Local Taxes	$2,836.7	$3,890.7	$3,685.7	$4,567.4	$5,732.9
% Change	---	37.2%	-5.3%	23.9%	25.5%
Total S&L Taxes Paid by Business	$6,866.5	$8,435.8	$10,352.6	$12,130.8	$13,666.9
% Change	---	22.9%	22.7%	17.2%	12.7%
Total S&L Business Taxes Adjusted for Inflation	$6,866.5	$7,038.7	$7,425.8	$7,625.9	$7,650.6
% Change	---	2.5%	5.5%	2.7%	0.3%
Addendum:					
Total State & Local Taxes Paid by All Taxpayers:					
State Government	$9,495.4	$11,143.8	$18,398.9	$23,381.2	$24,526.0
Local Government	6,039.0	8,482.5	6,559.4	8,731.6	11,556.6
Total S&L Government Taxes	$15,534.4	$19,626.3	$24,958.3	$32,112.8	$36,082.6
% Change	---	26.3%	27.2%	28.7%	12.4%

Source: Senate Fiscal Agency

The other major difference in the growth of State business tax revenue versus local business tax revenue occurred during the five-year period from FY 1999-2000 to FY 2004-05. During this time period, the growth in the revenue paid by businesses for State government taxes slowed to 4.9% compared with a 25.5% increase in business tax payments to local governments. This much slower rate of growth in State taxes is attributable to numerous tax cuts that were enacted during this five-year period, particularly cuts to the SBT, and to the slowdown in economic growth. The slowdown in economic growth had a much larger negative impact on State business tax collections than it did on local property tax collections.

THE SINGLE BUSINESS TAX: MICHIGAN'S MAJOR BUSINESS TAX

The SBT has been in existence for 30 years. It was enacted in 1975 and its first revenue was collected in FY 1975-76. The SBT is a type of value-added tax, which makes it a unique tax among the 50 states. The tax has been changed significantly since it was first enacted. Over the years many deductions, credits, and exemptions have been eliminated, replaced, or added to the tax. As a result, the tax has moved away from its original value-added concept and has become very complicated and very unpopular among the business community.

Taxes the Single Business Tax Replaced

When the SBT was adopted in 1975, it replaced several taxes assessed on businesses. In addition to the corporate income tax, the SBT replaced six other State taxes and one local tax. The name "single" business tax comes from the fact that this single new tax was replacing several other taxes. Of these eight taxes that were replaced, the most significant ones in terms of the amount of revenue they generated were the State corporate income and franchise taxes, and the local property tax on business inventories. All eight repealed taxes are listed in Table 3 along with their revenue levels for FY 1970-71 through FY 1973-74.

Table 3

MICHIGAN TAXES REPLACED BY THE SINGLE BUSINESS TAX (Millions of Dollars)

Tax	FY 1970-71	FY 1971-72	FY 1972-73	FY 1973-74
	Total Revenue			
Corporate Income Tax	$152.6	$269.2	$368.0	$295.1
Corporate Franchise Fee	132.9	140.2	153.4	157.7
Inventory Property Tax	223.3	231.2	238.9	253.0
Financial Institutions Tax	12.2	14.0	13.4	17.1
Intangibles Tax (business portion)	27.3	26.8	30.2	28.8
Income Tax on Unincorporated Business	2.0	3.3	3.6	4.0
Saving and Loan Privilege Tax	0.3	0.4	0.5	0.6
Insurance Privilege Tax	1.0	1.1	0.9	1.2
Total Revenue	**$551.6**	**$686.2**	**$808.9**	**$757.5**
	Percentage of Total Revenue			
Corporate Income Tax	27.7%	39.2%	45.5%	39.0%
Corporate Franchise Fee	24.1	20.4	19.0	20.8
Inventory Property Tax	40.5	33.7	29.5	33.4
Financial Institutions Tax	2.2	2.0	1.7	2.3
Intangibles Tax (business portion)	4.9	3.9	3.7	3.8
Income Tax on Unincorporated Business	0.4	0.5	0.4	0.5
Saving and Loan Privilege Tax	0.1	0.1	0.1	0.1
Insurance Privilege Tax	0.2	0.2	0.1	0.2
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Senate Fiscal Agency; State of Michigan Comprehensive Financial Report, various years; "The Michigan Single Business Tax", Advisory Commission on Intergovernmental Relations, March 1978.

Why Michigan Adopted the Single Business Tax

Repealing eight existing business taxes and replacing them with one unique tax marked a major change in Michigan's business tax structure and this change was not easy. When the plan was first proposed by Governor Milliken, it was not very popular. It was finally adopted, however, due largely to a combination of three factors: 1) The corporate income tax had some shortcomings that were hurting the State budget and the business climate, 2) Michigan's business taxes were being blamed, at least in part by some and in a large part by others, for the State's poor business climate and economic performance, and 3) State government was facing a very large budget deficit.

Corporate Income Tax. In the 1960s and 1970s, Michigan's economy was even more dominated by the durable goods manufacturing sector than it is today. The volatile nature of the durable manufacturing sector caused large fluctuations in the manufacturers' financial success or lack thereof. This created significant swings in the level of corporate income tax receipts. For example, in FY 1970-71, corporate income tax receipts totaled $153.0 million and then in FY 1971-72 they jumped $116.0 million or 76.4% to $269.0 million. At today's price level, that would be equivalent to an increase of $540.0 million. These large swings in the corporate income tax helped create budget problems. Unexpected revenue growth one year led to increased spending only to be followed the next year by unexpected revenue shortfalls that required spending cuts and/or tax increases. In addition, businesses in the durable manufacturing sector were more than eager to eliminate the corporate income tax.

Michigan's Poor Economic and Business Climate. Michigan's unemployment rate averaged about 7.0% from 1970 to 1974 and then shot up to 12.5% in 1975. As a result, Michigan's unemployment rate averaged 7.8% from 1970 to 1975, which was 32.0% above the U.S. average. This volatility in Michigan's level of economic activity helped contribute to the image that Michigan was not a good place to do business. In addition, the combination of Michigan's corporate income tax, franchise tax, and property tax on business inventories also was claimed to be a factor that was hurting Michigan's business climate. Proponents of the SBT argued that the SBT, through its capital acquisition deduction, would greatly reduce the tax burden on capital, compared with the corporate income tax, which would help encourage capital investment and business expansion, and help create new jobs.

Looming Budget Deficit. The State faced a budget deficit in FY 1975-76 of about $180.0 million (equivalent to about $840.0 million in today's dollars). Due to the timing of payments under the SBT, which is largely paid on a quarterly basis, and the corporate franchise tax, which was paid on an annual basis, switching to the SBT generated a cash flow gain of about $180.0 million in FY 1975-76 and thus eliminated the need to make significant spending cuts.

Value-Added Tax

The SBT is a type of value-added tax. A typical business purchases inputs to make its product or provide its service and the difference between the cost of these inputs and the amount the business receives from selling the goods or service is the amount of value the business adds to the product or service. This value that a business adds to its products or services is essentially the base of a value-added tax. Michigan uses the additive method to calculate value added and the major components of the base of Michigan's SBT are compensation paid to workers, which accounted for 70.0% of the tax base in 2001, and business income or profit, which was 12.0% of the 2001 tax base.

Alternative Adjustments to the Tax Base

In addition to using the straight value-added tax base, some businesses may adjust their tax base using the excess compensation or gross receipts reductions. Under the excess compensation reduction, a business whose compensation accounts for more than 63.0% of its tax base may deduct the amount of compensation that exceeds 63.0% from the firm's tax base. Under the gross receipts reduction, if a business's tax base exceeds 50.0% of its gross receipts, then the business may reduce its tax base by the amount that its tax base exceeds 50.0% of its gross receipts. The SBT also provides a small business credit and an alternative tax based on income, which are designed to help reduce the tax burden on smaller, less profitable businesses. While these special features of the SBT are designed to provide tax relief to particular businesses, they add to the complexity of the tax.

Types of Firms Subject to the Single Business Tax

While corporate income taxes are assessed only on corporations, Michigan's SBT is assessed on all types of firms. In addition to corporations (referred to as C corporations), the SBT is assessed on S corporations, sole proprietorships, and partnerships. An S corporation is a corporation that under certain circumstances is not subject to the Federal corporate income tax as long as its profits are distributed to its owners and they in turn pay the individual income tax. Table 4 provides a breakdown of SBT filings and liability by type of firm. In terms of total returns filed, C corporations accounted for 38.0%, followed by S corporations at 32.6%, partnerships at 19.1%, and sole proprietors at 10.3%. In terms of the amount of tax liability paid, C corporations accounted for 68.5%, while S corporations accounted for 18.0%, partnerships 11.8%, and sole proprietors 1.6%.

Table 4

SINGLE BUSINESS TAX RETURNS AND REVENUE BY TYPE OF FIRM, 2000-2001
(Millions of Dollars)

Type of Firm	Number of Firms[1]	Percent Distribution	Tax Liability	Percent Distribution
Sole Proprietors	15,260	10.3%	$33.0	1.6%
S Corporations	48,477	32.6	380.1	18.0
C Corporations	56,599	38.0	1,444.0	68.5
Partnerships, LLCs, Other	28,428	19.1	249.4	11.8
Total	**$148,764**	**100.0%**	**$2,106.5**	**100.0%**

[1] Firms that filed a return.

Source: Michigan Department of Treasury, "The Michigan Single Business Tax 2000-2001", February 2006.

Distribution of the Tax Liability

Table 5 provides a breakdown of how many firms pay the SBT. Out of the 194,000 firms in Michigan in 2001, 44.6% did not owe any tax, 42.4% of the firms paid about 10.0% of the single business tax total liability, and 13.0% of the firms paid about 90.0% of the liability. Of this last group, 461 firms paid about 35.0% of the total tax.

SBT Liability by Business Sectors

Figure 3 presents the percentage distribution of the total SBT liability for 2001 by major business sectors compared with the distribution of total business activity, as measured by Michigan Gross State Product (GSP). In 2001, manufacturing businesses paid 27.6% of the total SBT liability, which was largest share of any sector. The next largest shares of total SBT liability were accounted for by the service sector at 22.3%, finance insurance, and real estate at 14.6%, and retail trade at 13.4%. As shown in Figure 3, the distribution of SBT liability by sector was similar to the distribution of GSP by business sector, particularly for the construction, manufacturing, and service sectors. The sectors with the largest differences between SBT liability and GSP were the retail sector and the finance, insurance, and real estate (FIRE) sector. The retail sector's share of SBT liability exceeded its share of GSP product by three percentage points, while the finance, insurance, and real estate sector's share of total SBT liability was less than its GSP share by almost two percentage points.

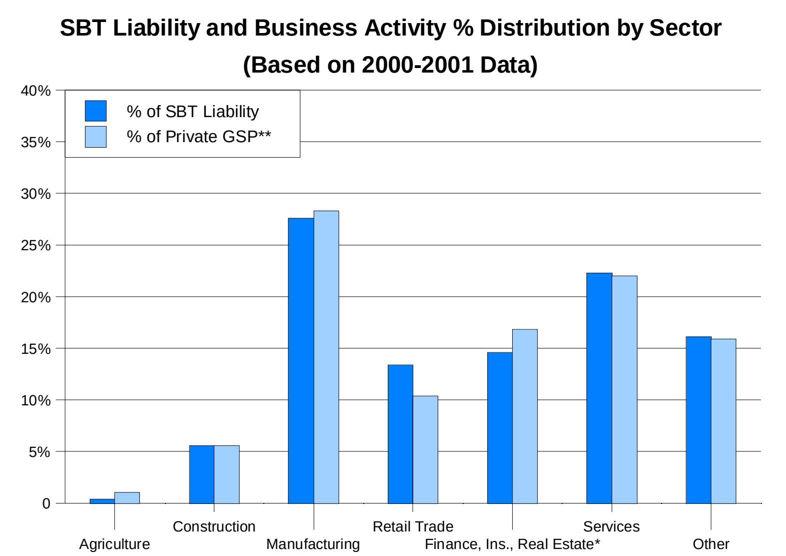
Table 5

WHO PAYS THE SINGLE BUSINESS TAX BY SIZE OF LIABILITY BASED ON 2000-2001 DATA (Millions of Dollars)

	Number	% of Total Businesses	Total Tax Liability	% of Total Tax
Total Businesses	193,861	100.0%	$2,106.6	100.0%
Did Not File	45,097	23.3	0.0	0.0
Filed But No Tax	41,241	21.3	0.0	0.0
Had a Tax Liability:				
< $1,000................................	25,399	13.1	11.6	0.5
$1,000-$9,999.......................	56,845	29.3	207.3	9.8
$10,000-$49,999..................	18,803	9.7	409.7	19.4
$50,000-$499,999................	6,015	3.1	748.5	35.5
>$499,999............................	461	0.2	729.5	34.6
Subtotal: With Liability...........	**107,523**	**55.5%**	**$2,106.6**	**100.0%**

Source: Michigan Department of Treasury, "The Michigan Single Business Tax 2000-2001", February 2006.

Figure 3



* Includes SBT and retaliatory tax paid by insurance companies. ** Gross State Product.

Source: Compiled by Senate Fiscal Agency using data from Michigan Department of Treasury, "The Michigan Single Business Tax 2000-2001", February 2006; and the U.S. Department of Commerce, Bureau of Economic Analysis.

Single Business Tax Revenue

Table 6 presents a history of the revenue generated by the SBT. In general, the level of revenue generated by the SBT reflects the cyclical nature of economic activity from FY 1976-77 through FY 1998-99. Single business tax revenue declined in the early 1980s when the economy was in a severe recession and then it grew during most of the years from FY 1982-83 through FY 1988-89 when economic activity was expanding. In 1990 another recession hit and as a result, SBT revenue declined in FY 1989-90 and FY 1990-91. The record-breaking economic expansion following the

1990 recession helped boost SBT revenue higher every year from FY 1991-92 to FY 1998-99. The $2.36 billion collected in FY 1998-99 has never been exceeded. After declining for five consecutive years, SBT revenue increased in FY 2004-05 by 3.6% to $1.9 billion, but remained below the FY 1998-99 level by almost 20.0%. This overall decline in SBT revenue since FY 1999-2000 was due to two major factors: 1) the prolonged contraction of the Michigan economy, and 2) enacted reductions in the SBT. It is estimated that the tax reductions enacted from 1999 to 2006 reduced SBT collections about $460.0 million in FY 2004-05, as shown in Table 7. In addition, if Michigan's economy had continued to grow from 2000 to 2005 at its historical average growth rate, SBT revenue would have topped $3.0 billion in FY 2004-05. This decline in SBT collections is further illustrated in Figure 4, which presents the history of SBT collections in both nominal and inflation-adjusted dollars. When adjusted for inflation, SBT collections from FY 2000-01 through FY 2004-05 represent some of the lowest annual collections in the history of the tax.

Table 6

Single Business Tax Revenue History[1)]
(Millions of Dollars)

Fiscal Year	Single Business Tax Revenue	% Change From Prior Fiscal Year	% of Total State Taxes	% of Michigan Personal Income
1975-76	$354.9	---	9.0%	0.6%
1976-77	803.5	126.4%	16.9	1.1%
1977-78	899.4	11.9	16.7	1.1
1978-79	1,001.3	11.3	16.6	1.1
1979-80	1,076.0	7.5	17.6	1.2
1980-81	942.2	(12.4)	15.2	0.9
1981-82	943.1	0.1	14.8	0.9
1982-83	1,041.7	10.5	14.1	1.0
1983-84	1,280.5	22.9	15.1	1.1
1984-85	1,378.4	7.6	15.3	1.0
1985-86	1,526.6	10.8	16.4	1.1
1986-87	1,497.6	(1.9)	13.9	1.0
1987-88	1,804.1	20.5	15.9	1.2
1988-89	1,845.4	2.3	15.5	1.1
1989-90	1,798.6	-2.5	14.8	1.0
1990-91	1,573.7	(12.5)	12.3	0.9
1991-92	1,685.1	7.1	12.6	0.9
1992-93	1,791.1	6.3	12.7	0.9
1993-94	2,035.4	13.6	12.4	1.0
1994-95	2,130.4	4.7	11.3	0.9
1995-96	2,187.4	2.7	11.1	0.9
1996-97	2,224.3	1.7	10.8	0.9
1997-98	2,349.1	5.6	10.8	0.9
1998-99	2,360.5	0.5	10.3	0.9
1999-00	2,324.9	(1.5)	9.7	0.8
2000-01	2,022.9	(13.0)	8.6	0.7
2001-02	1,983.8	(1.9)	8.4	0.7
2002-03	1,843.1	(7.1)	7.6	0.6
2003-04	1,841.0	(0.1)	7.5	0.6
2004-05	1,907.2	3.6	7.5	0.6

[1)] Does not include single business tax paid by insurance companies that is reported separately as part of the insurance tax, because there is no consistent historical series.

Source: Michigan Department of Management and Budget, "Michigan Comprehensive Annual Financial Reports" and compiled by Senate Fiscal Agency.

Disposition of Single Business Tax Revenue

None of the revenue generated by the SBT is earmarked for any special purposes, so all of the SBT revenue goes into the General Purpose portion of the General Fund (GF/GP). In FY 2004-05, the $1.9 billion in SBT revenue accounted for 20.8% of total GF/GP revenue.

Figure 4

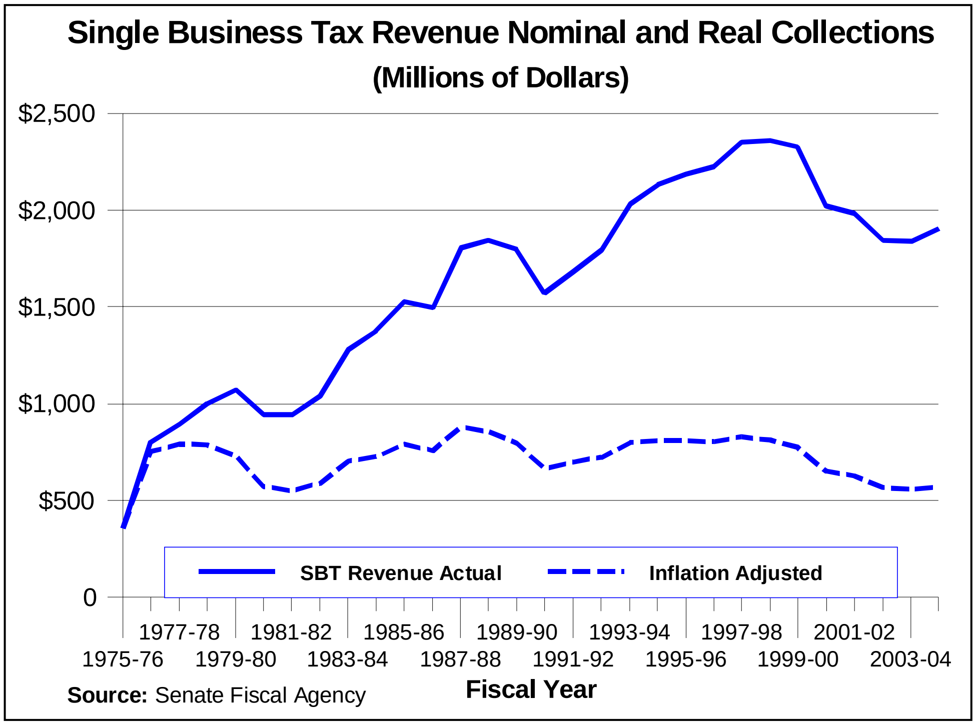


Table 7

SINGLE BUSINESS TAX REDUCTIONS ENACTED SINCE FY 1998-99
(Millions of Dollars)

Single Business Tax	Effect. Date	FY 1998-99	FY '99-2000	FY '00-'01	FY '01-'02	FY '02-'03	FY '03-'04	FY '04-'05	FY '05-'06	FY '99 - FY '06
Historic Preservation Credit	Jan 1999	$(1)	$(1)	$(1)	$(1)	$(1)	$(1)	$(1)	$(2)	$(9)
Tax Rate Phased Reduction[1)]	Jan 1999	(88)	(209)	(310)	(409)	(388)	(387)	(403)	(405)	(2,598)
Investment Tax Credit Increase for Small Business	Jan 2000		(12)	(17)	(16)	(16)	(16)	(17)	(17)	(111)
Iron Ore Tax Credit	2001				(1)	(1)	(1)	(1)	(1)	(5)
Federal Tax Change (2001 Act)	2001				(1)	(1)	(1)	(1)	(1)	(5)
Federal Tax Change (2002 Act)	2002				(4)	(4)	(4)	(4)	(4)	(20)
Gross Receipts Filing Threshold Increased to $350,000	2002					(19)	(21)	(21)	(21)	(82)
Federal & State Research Grant Exemption	2004						0	(1)	(1)	(1)
Donated Auto Credit	2004						0	(0)	(0)	(0)
Phased Partial Exemption for Employee Health Care Costs	2004						(2)	(10)	(22)	(34)
Apprenticeship Credit Increase for Tool & Die Businesses	2004						0	(1)	(1)	(1)
Small Business New Worker Credit	2005 only						0	(1)	(1)	(2)
Manufacturing Personal Property Tax 15% Refundable Credit	2006								(95)	(95)
In-Sourcing Jobs Personal Property Tax Credit	2007								0	0
Apportionment Sales Factor Increase	2006								(9)	(9)
Total Single Business Tax Reductions		$(89)	$(222)	$(328)	$(432)	$(430)	$(433)	$(460)	$(580)	$(2,973)
[1)] SBT Tax Rate		2.2%	2.1%	2.0%	1.9%	1.9%	1.9%	1.9%	1.9%	

Source: Senate Fiscal Agency

MICHIGAN'S TAXES ON PERSONAL PROPERTY

While both real property and personal property owned by businesses are subject to property taxes in Michigan, individuals pay tax on their real property but receive an exemption on their personal property. Therefore, property taxes on personal property are paid only by businesses. Business personal property includes such items as machinery and equipment, computers, office furniture, and vehicles. Business personal property that is specifically exempt from taxation includes such items as special manufacturing tools and agricultural equipment. In addition, business inventories are exempt from property taxes. At one time Michigan did assess property taxes on business inventories, but this tax was repealed when the SBT was adopted in 1975.

Revenue from Property Taxes on Personal Property

Business personal property is subject to several property taxes. These include the general property tax, the State education tax, the industrial facilities tax, and the State utility property tax. As shown in Table 8, it is estimated that these taxes on business personal property generated $1.8 billion in 2005.

Table 8

MICHIGAN PERSONAL PROPERTY TAXES ESTIMATES FOR 2005
(Millions of Dollars)

Tax	Estimated Amount
General Property Tax	
Local Governments	$525.8
Schools	790.9
Subtotal – General Property Tax	$1,316.7
State Education Tax	172.7
Industrial and Commercial Facilities Taxes	215.0
State Utility Property Tax	84.0
Estimated Total Personal Property Taxes	**$1,788.4**

Source: Senate Fiscal Agency estimates based on data from the State Tax Commission

General Property Tax. The general property tax is by far the largest property tax in Michigan in terms of the revenue it generates. It includes operating and debt millage for local governments, including cities, counties, townships, and villages, and K-12 public schools. The statewide average rate of these local property taxes is about 47 mills ($47 per $1,000 of taxable value). As a result, over 1,858 local units of government, 552 local school districts, and 57 intermediate school districts receive property tax revenue from business personal property. It is estimated that the general property tax generated approximately $1.3 billion from business personal property in 2005.

State Education Tax. The State education tax is a State tax on all property that is subject to the general property tax, including business personal property. The tax is levied at six mills ($6 per $1,000 of taxable value) and the revenue it produces is earmarked to the School Aid Fund. In 2005, this tax generated an estimated $173.0 million from business personal property.

Industrial Facilities Tax. The industrial facilities tax is a property tax assessed in lieu of the general property tax for industrial property granted an exemption certificate in a plant rehabilitation or industrial development district. These exemptions are granted for up to 12 years for restoring an existing facility or building a new facility. The industrial facilities tax on facilities being restored equals the local tax rate plus the State education tax rate times the taxable value of the facility before it was restored. The tax on new facilities is the taxable value of the new facility times one-half of the local millage rate plus the State education tax rate. The revenue from the industrial facilities tax is distributed in the same way as the general property tax, except the local school district's portion goes to the State School Aid Fund. It is estimated that the industrial facilities tax generated $215.0 million in personal property taxes in 2005.

Utility Property Tax. The utility property tax is a State tax on all property owned by telephone, railroad, and railroad car companies. This tax is in lieu of the general property tax. The tax is assessed on the taxable value of real and personal property and the tax rate is equal to the statewide average millage rate assessed on all other business property in the previous calendar year. Railroad-related companies receive some tax credits that essentially offset their tax liability. The portion of this tax generated from personal property is estimated at $84.0 million in 2005. All revenue from the utility property tax is deposited into the State's GF/GP budget.

MICHIGAN'S BUSINESS TAX BURDEN

While the amount of State and local taxes paid by businesses has increased steadily over the past 20 years, the raw tax data do not provide any information on how the tax burden on businesses has changed over this period of time. For example, from FY 1984-85 to FY 2004-05, the amount of State and local taxes directly paid by businesses in Michigan doubled, but this does not provide any indication as to whether the tax burden on business increased or decreased. Two common ways to measure the tax burden on businesses are: 1) calculate taxes paid by business as a percentage of their business activity, and 2) calculate taxes paid by businesses as a percentage of overall taxes paid by all taxpayers. Each of these types of tax burden measures is presented below, along with a comparison of how Michigan's business tax burden compares with the tax burden in other states.

Business Taxes as a Percentage of GSP

Gross State Product (GSP) measures the total value of the final goods and services produced in Michigan, and therefore is a good indicator of Michigan's overall business activity. Michigan's tax burden on businesses can be measured by calculating the percentage that the revenue generated from taxes directly paid by business taxes is of total business activity or GSP. Business taxes paid as a percentage of GSP are presented in Table 9 and Figure 5 for selected years from FY 1984-85 to FY 2004-05.

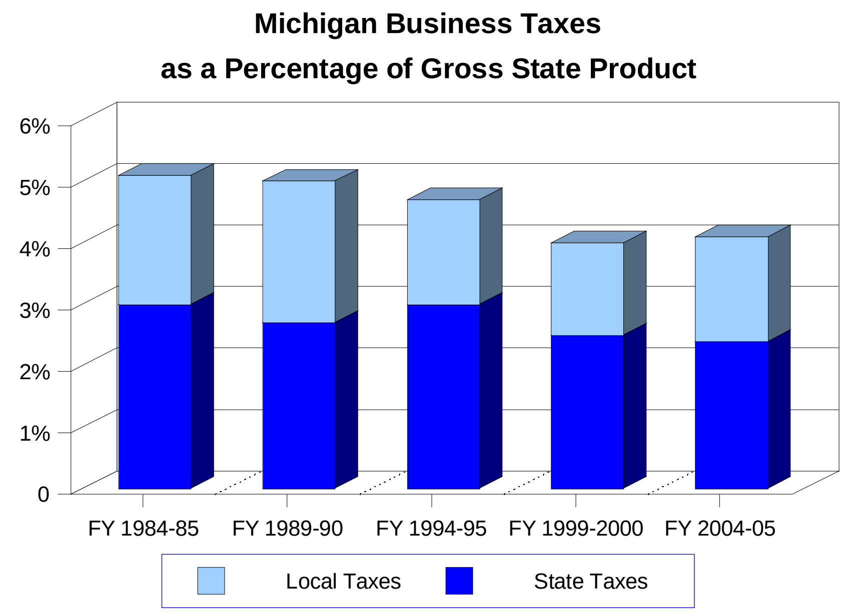
Table 9

MICHIGAN STATE AND LOCAL TAXES PAID BY BUSINESS (Millions of Dollars)

	FY 1984-85	FY 1989-90	FY 1994-95	FY 1999-2000	FY 2004-05
Taxes Paid by Business:					
State Taxes	$4,029.8	$4,545.1	$6,666.9	$7,563.4	$7,933.9
Local Taxes	2,836.7	3,890.7	3,685.7	4,567.4	5,732.9
Total State & Local Taxes	$6,866.5	$8,435.8	$10,352.6	$12,130.8	$13,666.9
% Change in Business Taxes:					
State Taxes	---	12.8%	46.7%	13.4%	4.9%
Local Taxes	---	37.2	(5.3)	23.9	25.5
Total State & Local Taxes	---	22.9%	22.7%	17.2%	12.7%
Business Taxes as % of Gross State Product:					
State Taxes	3.0%	2.7%	3.0%	2.5%	2.4%
Local Taxes	2.1	2.3	1.7	1.5	1.7
Total State & Local Taxes	5.1%	5.1%	4.7%	4.0%	4.0%
Business Taxes as % of Total Taxes:					
State Taxes	42.4%	40.8%	36.2%	32.3%	32.3%
Local Taxes	47.0	45.9	56.2	52.3	49.6
Total State & Local Taxes	44.2%	43.0%	41.5%	37.8%	37.9%

Source: Senate Fiscal Agency

Figure 5



Source: Estimated by Senate Fiscal Agency

State and Local Tax Burden. Total State and local taxes paid by Michigan's businesses as a percentage of GSP declined from 5.1% in FY 1984-85 to 4.7% in FY 1994-95 and then dropped to 4.0% in FY 1999-2000. In FY 2004-05, total State and local taxes paid by businesses as a percentage of GSP remained at 4.0%.

State versus Local Government Tax Burden. The business tax burden due to only State government taxes measured 3.0% in FY 1984-85 and 2.7% in FY 1989-90, while the tax burden for only local taxes rose from 2.1% in FY 1984-85 to 2.3% in FY 1989-90. In FY 1994-95, the tax restructuring that occurred due to Proposal A boosted the State tax burden to 3.0% and reduced the local tax burden to 1.7%. Since then, the State tax burden fell to 2.5% of GSP in FY 1999-2000 and to 2.4% in FY 2004-05 and the local tax burden has remained in the 1.5% to 1.7% range.

Business Taxes as a Percentage of Total Tax Payments

Table 9 presents estimates of the business tax burden based on the business share of total State and local taxes paid by all taxpayers. In FY 1984-85, businesses paid 44.2% of total State and local taxes collected in Michigan. The business share of total taxes then trended downward as it fell to 43.0% in FY 1989-90, 41.5% in FY 1994-95, and 37.8% in FY 1999-2000. Since FY 1999-2000, a number of reductions in business taxes, particularly the SBT have been enacted; however, numerous reductions to taxes paid by individuals also were enacted, and as a result, the share of total State and local taxes paid by businesses remained practically unchanged in FY 2004-05 from the FY 1999-2000 level.

State versus Local Taxes. The share of total State taxes paid by businesses declined steadily from 42.4% in FY 1984-85 to 32.3% in FY 1999-2000, and then remained at 32.3% in FY 2004-05. The business share of local taxes fell from 47.0% in FY 1984-85 to 45.9% in FY 1989-90. In FY 1994-95, school property taxes were cut for all taxpayers as part of Proposal A, but the reduction was greater for homeowners than it was for all other taxpayers including businesses. As a result, even though the amount of local taxes paid by businesses declined in FY 1994-95, the business share of total local taxes jumped up to 56.2%. Since then, the business share of local taxes fell to 52.3% in FY 1999-2000 and 49.6% in FY 2004-05. This decline in the business share of local taxes since FY 1994-95 is due to the fact that the growth in property taxes has been less for businesses than for individuals because the value of industrial and commercial property has been appreciating at a slower rate than the rate of residential property appreciation.

Michigan Business Tax Burden Compared with Other States

Comparing business tax burdens among states is not an easy task. Ever since Michigan adopted the SBT, many attempts at comparing tax burdens among states focused narrowly on the corporate income tax, which is the primary tax on business in most states. Because Michigan has no corporate income tax, some of these comparisons simply used the SBT to calculate Michigan's "comparable" business tax burden. However, comparing Michigan's SBT with corporate income taxes in other states is by no means a fair comparison. As noted earlier in this report, Michigan's SBT replaced eight other taxes, one of which was a corporate income tax. Therefore, a comparison today between Michigan's SBT and the corporate income tax in other states would be equivalent to making a comparison in the early 1970s between Michigan's corporate income tax and seven other Michigan business taxes, and only the corporate income tax in other states, which would clearly be a very unfair comparison.

In order for a comparison of business tax burdens among states to be accurate, the comparison must include: 1) estimates of all taxes paid by businesses for both direct business taxes and general taxes that are also paid by businesses, and 2) estimates of all taxes assessed on businesses by both state and local governments.

All Taxes Paid by Businesses. It is important to include the amount businesses pay for all taxes and not only taxes that are assessed solely on businesses. For example, as shown in Table 1, Michigan assesses three major taxes on businesses in general (SBT, personal property taxes, and unemployment insurance taxes), and levies several taxes on certain types of business (casino gaming, utility property, insurance companies, severance, horse race wagering, and industrial facilities taxes). These business taxes account for an estimated 40.0% of the total State and local taxes paid by businesses. The other 60.0% of the total State and local taxes paid by businesses are general taxes that levied on all taxpayers, including the sales, use, motor fuels, and vehicle registration taxes and the general property tax on real property. Omitting these general taxes would leave out the majority of the overall business tax liability and could result in very inaccurate estimates of the overall business tax burden.

State and Local Taxes Paid by Businesses. It is also important to include both state and local government taxes. The level of taxation that states allow their local governments to assess varies from state-to-state, and the amount of taxes a state allows its local governments to assess will probably have an impact on how much the state government assesses. Therefore, including only the amount of taxes paid by businesses to state governments would not provide an accurate or meaningful measure of the state's overall tax burden on business.

Ernst and Young, in conjunction with the Council on State Taxation (COST), conducted a study measuring the tax burden on businesses among the 50 states. This report includes state and local taxes paid by businesses, as well as estimates of the amount businesses paid in general and specific business taxes along with general taxes paid by all taxpayers. The results from the Ernst and Young report, which was released in March 2006, are summarized in Table 10.

According to this Ernst and Young report, in FY 2004-05, Michigan's business tax burden ranked 36th among the 50 states based on taxes paid as a percentage of GSP. This means that as a percentage of GSP, 35 other states had a business tax burden higher than Michigan's. Michigan's neighboring states of Illinois, Indiana, Minnesota, Ohio, and Wisconsin all had higher business tax burdens than Michigan's. Among some other major manufacturing states, Michigan had a business tax burden that was less than the tax burdens in California, Florida, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington, but was higher than the tax burdens in Massachusetts and North Carolina.

Table 10

STATE AND LOCAL BUSINESS TAX BURDEN BY STATE FY 2004-05
ESTIMATED BY ERNST AND YOUNG

State	Business Taxes Paid as % of Private GSP*	State Ranking	State	Business Taxes Paid as % of Private GSP*	State Ranking
Alabama	4.2%	40	Montana	5.4%	15
Alaska	9.3%	2	Nebraska	5.4%	15
Arizona	4.9%	23	Nevada	4.6%	29
Arkansas	4.3%	36	New Hampshire	5.1%	22
California	4.8%	25	New Jersey	4.5%	31
Colorado	4.1%	41	New Mexico	6.3%	5
Connecticut	3.9%	44	New York	5.7%	10
Delaware	3.7%	48	North Carolina	3.7%	48
Florida	5.4%	15	North Dakota	6.6%	3
Georgia	4.0%	42	Ohio	4.7%	27
Hawaii	5.4%	15	Oklahoma	5.5%	12
Idaho	4.3%	36	Oregon	3.8%	47
Illinois	5.3%	19	Pennsylvania	4.8%	25
Indiana	4.5%	31	Rhode Island	5.2%	20
Iowa	4.3%	36	South Carolina	4.4%	33
Kansas	5.5%	12	South Dakota	5.2%	20
Kentucky	4.4%	33	Tennessee	4.5%	30
Louisiana	6.2%	6	Texas	5.6%	11
Maine	5.9%	7	Utah	3.9%	44
Maryland	4.7%	27	Vermont	5.5%	12
Massachusetts	4.0%	42	Virginia	3.7%	48
Michigan	**4.3%**	**36**	Washington	5.8%	8
Minnesota	4.9%	23	West Virginia	6.6%	3
Mississippi	5.8%	8	Wisconsin	4.4%	33
Missouri	3.9%	44	Wyoming	9.6%	1
U.S.	4.8%		U.S.	4.8%	

GSP = Gross State Product (value of goods and services produced in each state). The GSP used was for private sector only.

Source: Ernst & Young, in conjunction with the Council on State Taxation, "Total State and Local Business Taxes", March 2006.

HOW OTHER STATES TAX BUSINESS

Every state assesses special taxes on businesses. While in general there are some similarities in how states structure their business taxes, there are also many differences when the details are revealed. Table 11 (on pages 24 and 25) provide a summary of the types of taxes each state assesses on businesses. The major similarities and differences are summarized in Table 11.

Corporate Income Tax: Forty-three states assess a corporate income tax, which makes it the most popular business tax among the states. Of these states, 31 have a flat tax rate structure (one tax rate for all income levels) that ranges from a low of 4.63% in Colorado to a high of 9.99% in Pennsylvania. The remaining 13 states have a progressive tax rate structure (in which the tax rate increases as income increases) and the highest marginal rate is 12.0% in Iowa. Table 12 presents a comparison of the state corporate income tax rate structures and rates.

Table 12

STATE CORPORATE INCOME TAX RATES
PROGRESSIVE VS FLAT RATE STRUCTURES AND TAX RATES
(As of January 1, 2006)

State	Progressive or Flat Rate Structure	Tax Rate (Top Marginal Rate if Progressive)	State	Progressive or Flat Rate Structure	Tax Rate (Top Marginal Rate if Progressive)
Alabama	Flat	6.5	Montana	Flat	6.75
Alaska	Progressive	9.4	Nebraska	Progressive	7.81
Arizona	Flat	6.968	Nevada	No Corporate Income Tax	
Arkansas	Progressive	6.5	New Hampshire	Flat	8.5
California	Flat	10.84	New Jersey	Flat	9.0
Colorado	Flat	4.63	New Mexico	Progressive	7.6
Connecticut	Flat	7.5	New York	Flat	7.5
Delaware	Flat	8.7	North Carolina	Flat	6.9
Florida	Flat	5.5	North Dakota	Progressive	7.0
Georgia	Flat	6.0	Ohio	Progressive	8.5
Hawaii	Progressive	6.4	Oklahoma	Flat	6.0
Idaho	Flat	7.6	Oregon	Flat	6.6
Illinois	Flat	7.3	Pennsylvania	Flat	9.99
Indiana	Flat	8.5	Rhode Island	Flat	9.0
Iowa	Progressive	12.0	South Carolina	Flat	5.0
Kansas	Flat	7.35	South Dakota	No Corporate Income Tax	
Kentucky	Progressive	7.0	Tennessee	Flat	6.5
Louisiana	Progressive	8.0	Texas	No Corporate Income Tax	
Maine	Progressive	8.93	Utah	Flat	5.0
Maryland	Flat	7.0	Vermont	Progressive	9.75
Massachusetts	Flat	9.5	Virginia	Flat	6.0
Michigan	**No Corporate Income Tax**		Washington	No Corporate Income Tax	
Minnesota	Flat	9.8	West Virginia	Flat	9.0
Mississippi	Progressive	5.0	Wisconsin	Flat	7.9
Missouri	Flat	6.25	Wyoming	No Corporate Income Tax	

Source: Federation of Tax Administrators.

In addition, among these 43 states with a corporate income tax:

- 11 states have a minimum corporate income tax.
- 4 states require businesses to pay the greater of a corporate income tax or a net worth tax.
- 14 states extend their tax base to S corporations and/or partnerships.

Value Added Tax. Two states assess a value-added tax. Michigan assesses the SBT and New Hampshire assesses a modified value-added tax called the Business Enterprise Tax that is in addition to the state's corporate income tax.

Other Major Business Taxes. Six states assess some other type of tax as a major business tax:

- Alaska levies a special oil production tax.
- Delaware levies a gross receipts tax on business receipts from goods sold and services rendered.
- Nevada levies a tax on wages paid to employees.
- Ohio is phasing in a new gross receipts tax to replace its corporate income tax.
- Tennessee levies a privilege tax on various professions and a business tax on the gross income of certain businesses, both in addition to the corporate income tax.
- Washington levies the business and occupation tax, which is a gross receipts tax that has varying rates for different industry classifications.

Franchise Tax. Seventeen states assess a franchise or net worth tax. All of these taxes are in addition to the corporate income tax except in Wyoming, which does not have a corporate income tax.

Property Tax on Inventories. Fourteen states levy a property tax on business inventories.

Personal Property Tax. Thirty-nine states assess a property tax on at least some of the personal property owned by businesses.

Table 11

MAJOR BUSINESS TAXES ASSESSED BY STATES											
	Corporate Income Tax (CIT)							Special Financial Institutions Tax			
State	Total	Includes a Minimum Tax	CIT or Net Worth Tax	Taxes S-Corps (S) and/or Partners. (P)	Value Added Tax (VAT)	Other Major Business Tax	Franchise Tax (Net Worth Tax)	Net Worth Tax	Income Tax	Local Property Tax on Inventories	Tax on Business Personal Property
Alabama	X						X		X		X
Alaska	X					X[1]				X	X
Arizona	X	X									X
Arkansas	X						X			X	X
California	X	X		S							X
Colorado	X										X
Connecticut	X		X	S,P							X
Delaware	X					X[2]	X		X		
Florida	X										X
Georgia	X						X	X		X	X
Hawaii	X								X		
Idaho	X	X									X
Illinois	X			S,P			X				
Indiana	X								X	X	X
Iowa	X								X		
Kansas	X						X		X		X
Kentucky	X	X					X			X	X
Louisiana	X			S			X			X	X
Maine	X										X
Maryland	X						X			X	X
Massachusetts	X	X							X	X	X
Michigan					X						X
Minnesota	X			P							X
Mississippi	X			S			X			X	X
Missouri	X								X		X
Montana	X	X									X
Nebraska	X						X	X			X
Nevada						X[3]					X
New Hampshire	X			S,P	X						
New Jersey	X	X		S							

Table 11

MAJOR BUSINESS TAXES ASSESSED BY STATES											
	Corporate Income Tax (CIT)							Special Financial Institutions Tax			
State	Total	Includes a Minimum Tax	CIT or Net Worth Tax	Taxes S-Corps (S) and/or Partners. (P)	Value Added Tax (VAT)	Other Major Business Tax	Franchise Tax (Net Worth Tax)	Net Worth Tax	Income Tax	Local Property Tax on Inventories	Tax on Business Personal Property
New Mexico	X	X									
New York	X		X	S				X			
North Carolina	X						X				X
North Dakota	X								X		X
Ohio				S,P		X[4]					
Oklahoma	X						X			X	X
Oregon	X	X									X
Pennsylvania	X						X	X			
Rhode Island	X		X								X
South Carolina	X						X		X		X
South Dakota									X		
Tennessee	X			S,P		X[5]	X				X
Texas						X[6]	X			X	X
Utah	X	X									X
Vermont	X	X		S,P				X		X	X
Virginia	X			S				X		X	X
Washington						X[7]					X
West Virginia	X		X	S						X	X
Wisconsin	X										X
Wyoming							X				X
No. of States	43	11	4	14	2	7	18	6	11	14	39

1) Alaska levies an oil production tax.
2) Delaware levies a gross receipts tax on goods sold and services rendered and the rates range from 0.096% to 1.92%, depending on the business activity.
3) Nevada levies a tax on wages paid to employees.
4) Ohio is phasing in a gross receipts tax over five years to replace its corporate income tax.
5) Tennessee levies a privilege tax on various professions and a business tax on the gross income of certain businesses, both in addition to the CIT.
6) Texas recently adopted a "margin" tax. It is described later in this report.
7) Washington assesses the business and occupation tax, which is a gross receipts tax. The tax rate varies among the different industries.

Compiled by the Senate Fiscal Agency using various sources, including "State Tax Guide", by Commerce Clearing House and information from individual states.

States That Have Recently Restructured Their Business Taxes

Ohio and Texas have recently made some significant changes in how they tax businesses. The changes enacted by these states are summarized below.

Ohio Business Tax Reform

In 2005, Ohio enacted sweeping changes to its tax structure. The major change was to enact a new business tax called the Commercial Activity Tax (CAT), but several other taxes also were changed or repealed. Many of these enacted tax changes are being phased in over several years. The highlights of Ohio's tax changes are summarized below.

Commercial Activity Tax. This is essentially a broad-based, low-rate business gross receipts tax. The new tax became effective July 1, 2005 (the beginning of FY 2005-06), and is replacing the corporate franchise tax (described below). The transition to the CAT and away from the corporate franchise tax is being phased in over a five-year period. The CAT is assessed on corporations, sole proprietors, partnerships, and limited liability companies, and on most types of business, such as retailers, wholesalers, manufacturers, and service providers, including doctors, lawyers, and accountants. The major types of business not subject to the CAT are financial institutions, dealers in intangible property, insurance companies, and some public utilities. These types of business will continue to pay Ohio's corporate franchise tax. Another key feature of this tax is that it applies to all property and services that are delivered to a location in Ohio.

The CAT has essentially two parts: 1) a business privilege tax, and 2) a gross receipts tax. Firms with gross receipts less than $150,000 do not pay either tax. Businesses with gross receipts from $150,000 to $1.0 million pay a flat privilege tax of $150. Businesses with gross receipts in excess of $1.0 million pay the $150 privilege tax plus a gross receipts tax on their gross receipts in excess of $1.0 million. Ohio is phasing in the CAT over a five-year period by implementing the 0.26% tax rate in 20.0% increments each year from 2005 through 2009.

Another interesting feature of this new tax gives the Ohio Tax Commissioner the authority to adjust the tax rate depending on the amount of revenue that is generated from this new tax. If revenue collections come in 10.0% or more above or below the projected revenue level, then the Ohio Tax Commissioner is required to raise or lower the rate to bring collections more in line with the estimates. The first adjustment will be made based on collections during the FY 2005-06 and FY 2006-07. At this point in time, tax collections are running ahead of the original estimates, but it does not look like they will be up by more than 10.0% over these two years.

Other Ohio Tax Changes

Corporate Franchise Tax. As mentioned above, this tax will be phased out from 2005 to 2009 by 20.0% increments for all businesses that are subject to the new CAT. The corporate franchise tax is a tax on corporate business income (5.1% on the first $50,000 of taxable business income and 8.5% on taxable business income in excess of $50,000) or a business's net worth (net worth times four mills with a maximum liability of $150,000), whichever is greater.

Sales Tax. The sales tax rate was reduced from 6.0% to 5.5% effective July 1, 2005.

Income Tax. Ohio's individual income tax has a progressive rate structure that includes nine tax brackets. Under this tax reform package, these income tax rates were cut 4.2% in 2005 and will be cut another 4.2% in each of the next four years, for a total tax cut of 21.0% for tax years beginning in 2009.

Personal Property Tax. The tax on tangible personal property, which is assessed only on business personal property and goods held in inventory, is being eliminated. New manufacturing machinery and equipment first on the tax rolls in 2006 or after will be exempt from the personal property tax. The tax on all other business personal property will be phased out and eliminated by 2009.

Cigarette Tax. The cigarette excise tax was increased from $0.55 per pack to $1.25 per pack effective July 1, 2005.

Real Property Tax. A 10.0% rollback in real property business taxes that was in effect prior to the enactment of this new tax reform package was eliminated beginning in 2006.

Fiscal Impact. It is estimated by the Ohio Department of Treasury that this tax restructuring will result in an overall tax reduction ranging from an estimated $436.0 million in FY 2005-06 to over $2.0 billion by FY 2008-09.

Texas Business Tax Reform

In May 2006, Texas enacted legislation that replaces its existing franchise tax with a so-called "margin" tax. Under this new tax, a business will calculate the base of the tax three different ways and then use the smallest of these calculations as the base for calculating its tax liability. The three tax base calculations are:

1) Cost-of-goods-sold margin: Total revenue less cost of goods sold. Cost of goods sold includes all direct costs of acquiring or producing goods, such as labor, materials, processing, assembly, transportation, storage, and depreciation. The cost-of-goods-sold margin calculation is not available to businesses that provide only services. The major component of the cost-of-goods-sold margin is profit or business income.

2) Compensation margin: Total revenue less wages, other cash compensation, and employee benefits. Wages and cash compensation include Medicare wages; net distributive income from partnerships, limited liability companies, and S corporations; stock awards and options; and compensation paid to officers, directors, owners, partners, and employees. The total compensation deduction for any one employee may not exceed $300,000. Employee benefits include benefits provided to all workers for workers' compensation, health care, and retirement benefits, to the extent that they are deductible under the Federal income tax. For most taxpayers that will use this tax base calculation, the major component of the resulting "margin" will be profit or business income.

3) Percent margin: 70.0% of total revenue. This calculation effectively limits the taxable margin amount to a maximum of 70.0% of total revenue for all taxpayers.

Apportionment. The smallest of the three margin calculations then is apportioned to Texas using a one-factor formula based on the ratio of gross receipts in Texas to gross receipts everywhere.

Tax Rate. The tax rate for this tax equals 0.5% for retailers and wholesalers and 1.0% for all other businesses. If a business has total revenue of $300,000 or less, or its tax liability is less than $1,000, the taxpayer does not have to pay any tax.

Credits. Taxpayers that qualified for the research and development credit, capital investment credit, or job creation credit under the previous franchise tax, may claim any unused credits against the margin tax; however, each credit is limited to 50.0% of the before-credit liability. A credit on business losses that were accrued before January 1, 2008, also may be claimed and the credit will equal 10.0% of the losses times the margin tax rate. No new credits are granted under the margin tax.

KEY PRINCIPLES FOR EVALUATING ALTERNATIVE BUSINESS TAXES

There is no clear empirical way of measuring whether one tax is "better" than another, but most economists believe that tax systems should adhere to three major principles: reliability, equity, and efficiency. Following is a brief description of each of these principles.

Reliability

Reliability has two major components: stability and sufficiency. Taxes are levied for the purpose of funding government spending. Like most states, Michigan is required by its Constitution to have a balanced budget. Therefore, it is important to have taxes that provide a relatively stable level of revenue. Taxes whose revenue streams are prone to unpredictable fluctuations lead to an unstable tax structure, which interferes with the delivery of government provided goods and services and has a negative impact on economic activity. One way to help make tax revenue more stable is to broaden the base of the tax. The narrower the tax base, the more susceptible it is to fluctuations. In addition to providing a stable flow of revenue, a tax should provide a sufficient level of revenue necessary to finance the desired level of spending.

Equity

Equity has two primary components -- horizontal equity and vertical equity. *Horizontal equity* refers to the question of whether "equals are treated equally". Two businesses in more-or-less equal financial situations should have similar tax burdens. For example, if two manufacturing firms have $100,000 in taxable income each, then in order to have horizontal equity a tax based on income should place the same tax burden on these two businesses. Horizontal equity also would apply to businesses in similar financial situations that are involved in different types of business or have different business structures. A manufacturing firm with $100,000 in taxable income should have a tax burden very similar to the tax burden on a retail store with $100,000 of taxable income. Similarly, two similar-sized businesses, one of which is a C-corporation and the other an S-corporation, should have a similar tax burden.

Vertical equity refers to the notion of fairness in how the tax burden is distributed among taxpayers that are not equal in terms of their ability to pay. Taxes are distributed among taxpayers in basically three different ways: progressively, proportionally, and regressively. Under a *progressive* tax, the share of income paid in taxes increases as income increases. When the share of income paid in taxes does not change as income changes, the tax burden is distributed *proportionally*. Under a *regressive* tax, the share of income paid in taxes decreases as income increases. Different types of taxes tend to be inherently more regressive or progressive. For example, the sales tax tends to be regressive and the income tax tends to be progressive. While there is by no means a consensus on whether a progressive, proportional, or regressive tax burden distribution is more equitable, three tenets are widely held among policy experts: 1) Each tax does not have to have the same level of vertical fairness, but the overall tax system should reflect the desired level of vertical equity, 2) a tax system should minimize regressivity, and 3) the tax burden on low income taxpayers should be minimized.

Efficiency

In addition to being reliable and equitable, a tax should be efficient. Taxes have three basic types of efficiency costs: administration costs, compliance costs, and market distortion costs.

Administration costs arise because it costs money for the government to collect taxes. *Compliance costs* arise because it costs taxpayers money – above and beyond the actual tax bill – to comply with the tax, including the money that businesses spend on accountants, tax lawyers, and tax preparers. *Economic costs* occur when taxes are not economically neutral. For example, tax policy can affect businesses' decisions on whether to hire labor or invest in capital. If tax policy distorts how businesses allocate resources, then the market is not operating most efficiently, which increases costs for consumers and businesses. A tax should have the smallest possible effect on the allocation of resources in the economy. The best way to reduce administration, compliance, and market distortion costs is to reduce the complexity of a tax and have a neutral impact on the factors of production. A broad-based tax with a low tax rate and no special deductions, exemptions, or credits would be the simplest tax for taxpayers to pay and governments to collect, and it also would help minimize market distortions.

Other Considerations and Terms

No Perfect Tax. All taxes have their strengths and weaknesses concerning such things as reliability, equity, and efficiency. There is no perfect tax. A flat "poll tax" levied on every citizen is a simple, efficient, and reliable source of revenue, but most policy-makers perceive such a tax as extremely unfair. Therefore, the best way to achieve reliability, equity, and efficiency is by using a balanced group of several different taxes that collectively help offset the weaknesses implicit in each individual tax.

Interstate Competition. State tax systems do not operate in a vacuum. The tax policies of surrounding states can limit the revenue potential of some taxes. Businesses that sell in a national or global marketplace often can relocate if business taxes in a particular state are too burdensome.

Ability to Pay versus Benefits Received. Two principles that support opposing methods for allocating the burden of a tax among taxpayers are the ability-to-pay concept and the benefits-received principle. The ability-to-pay concept argues that the tax burden should be distributed based on the financial situation of taxpayers. Taxpayers with higher incomes or profits should pay a greater share of the tax than is paid by taxpayers with lower incomes. The benefits-received principle argues that taxpayers should pay taxes based on the amount of public goods and services they use. The benefits-received principle is based on the belief that businesses should pay for the costs of the public goods and services they consume because these expenses are a cost of doing business, just like purchasing machinery and hiring workers are costs of doing business.

Bottom Line on a Good Business Tax

In order to provide a reliable source of revenue, with an equitable distribution of the tax burden that can be collected and paid with relatively low costs, the ideal business tax should:

- Be assessed on all types and forms of business;
- Have a broad base;
- Have a relatively low tax rate; and
- Have few special exemptions, deductions, or credits.

ALTERNATIVE BUSINESS TAXES – PROS AND CONS

This section of the report contains short summaries of the most common major business taxes among the states, along with some other potential taxes that could be possible replacements or partial replacements of the SBT. Major advantages and disadvantages of each of these alternative business tax structures also are presented.

Corporate Income Tax

The corporate income tax is the most popular business tax among the 50 states. States base their corporate income taxes on the Federal corporate income tax's definition of taxable income, which starts with gross profits (gross receipts less cost of goods sold) and adds dividends, interest, rent, royalties, and net income from capital gains and then deducts numerous expenses including payments to employees (wages, salaries, and benefits), officer compensation, taxes, charitable contributions, depreciation, and various other business expenses. The tax rate can be a flat rate or a progressive schedule and a state typically includes certain exemptions and credits.

Pros:
- Only corporations making a profit have to pay the tax.
- The tax is widely used, so compliance would be easy for multistate companies.
- The tax has been used for many years, so its long legal history helps create more certainty in the tax, for both state governments and taxpayers.

Cons:
- The revenue stream is extremely volatile.
- To replace the SBT and be revenue neutral, a corporate income tax would need to have a rate of about 15.0%, which would be much higher than any existing state corporate income tax rate.
- There is no direct relationship between profitability and dependence on government services, so in effect high-profit firms would be subsidizing low-profit ones.
- Only corporations pay the tax, so many businesses (noncorporations) avoid the tax.
- The tax is not neutral – it is a tax on capital.

Business Income Tax

A business income tax is the same as a corporate income tax but with a broader tax base. In addition to corporations, this tax would apply to other legal forms of business including partnerships, S corporations, and limited liability companies.

Pros:
- It would be more equitable than a corporate income tax because it would treat all businesses the same.
- The base would be broader than that of a corporate income tax, so the revenue stream would be more stable.
- In order to be revenue neutral compared with the SBT, it is estimated that the tax rate would have to be in the range of 7.0% to 8.0%, which would be a much lower rate than under a corporate tax rate and more in line with other states' taxes.

Cons:
- While it would not be as volatile as the corporate income tax, it still would be a relatively volatile source of revenue and more volatile than the SBT.

- There is no direct relationship between profitability and dependence on government services, so in effect high-profit firms would be subsidizing low-profit ones.
- The tax is not neutral – it is a tax on capital.

<u>Gross Receipts Tax</u>

A gross receipts tax is a tax on a business's total receipts from goods sold and services rendered. Such a tax does not provide any deductions for such items as the cost of goods or property sold, labor costs, interest expense, discounts paid, delivery costs, taxes paid, or any other expenses incurred. Given that gross receipts represent a broad measure of economic activity, a gross receipts tax can be applied to all types and legal forms of businesses, at a fairly low tax rate, and generate much revenue. Since the tax is assessed on businesses at all stages of production, the more stages that a product has and the more stages that are completed by different businesses, the higher the effective tax rate is. This is referred to as tax pyramiding, which creates tax distortions and inequities between companies, depending on how many inputs a company purchases from other companies. An example of tax pyramiding is presented in <u>Table 13</u> (on the following page).

Pros:
- It can be very broad based and therefore have a relatively low rate.
- It can generate much revenue and would be more stable than an income tax.
- It is potentially easier to comply with and administer than an income tax or the SBT.
- It has a neutral impact on the factors of production.

Cons:
- Tax pyramiding creates a competitive disadvantage for businesses that purchase their inputs from other firms compared with businesses that are vertically integrated.
- Businesses would have to pay the tax even if a business did not make a profit.
- While the tax burden would not be based on the ability-to-pay principle, this tax also would not be a good measure of the benefits received principle.
- It would be somewhat unique because it is not widely used among other states.

<u>Business License Fee/Tax</u>

A business license tax or fee can take a variety of different forms. The basic business license tax/fee is a fixed dollar amount per business. Such a tax does not have a tax rate and is not based on any economic activity or financial measure such as profits, value added, assets, stock, or sales. One variation of this tax has a different fixed dollar amount of tax for each of several ranges of sales or income. Such a tax whose brackets are based on sales is actually a cross between a business license tax and a gross receipts tax. Similarly, if the brackets are based on income, the tax represents a cross between a business license tax and an income tax.

Pros:
- The business license tax is a very simple tax, so it would be relatively easy and inexpensive for businesses to comply with and for government to administer.
- It would be a relatively stable source of revenue.
- A business's tax liability would be very predictable.

Cons:
- A basic business license tax would be very inequitable because small and large businesses would be taxed the same dollar amount.
- A basis business license tax would be limited in terms of the amount of revenue it could generate.

- Even a bracketed business license tax would have limited growth potential because the dollar amount of the tax per bracket would be fixed.
- The tax must be paid even if no profit is made.

Table 13

EXAMPLE OF TAX PYRAMIDING UNDER A GROSS RECEIPT TAX

	Separate Firms (Horizontal Firm Structure) Sales To:				
Sales From	**Steel Manufacturer**	**Component Manufacturer**	**Vehicle Manufacturer**	**Retailer**	**Vertically Integrated Firm**
Step 1: Basic Stage					
Ore/Materials Suppliers	$50,000				$50,000
Equipment/Utility/Other Costs	75,000				75,000
Labor Costs	40,000				40,000
Profit	10,000				10,000
Subtotal	$175,000				$175,000
Tax on Gross Receipts at 0.5% rate	$875				$0
Step 2: Intermediate Stage					
Steel Producers (See Step 1)		$175,875			
Equipment/Utility/Other Costs		45,225			$45,000
Labor Costs		50,000			50,000
Profit		5,000			5,000
Subtotal		$276,100			$100,000
Tax on Gross Receipts at 0.5% rate		$1,381			$0
Step 3: Final Production Stage					
Component Producers (See Step 2)			$277,481		
Equipment/Utility/Other Costs			60,300		$60,000
Labor Costs			60,000		60,000
Profit			5,000		5,000
Subtotal			$402,781		$125,000
Tax on Gross Receipts at 0.5% rate			$2,014		$0
Step 4: Retail Stage					
Vehicle Manufacturer (See Step 3)				$404,794	
Equipment/Utility/Other Costs				5,025	$5,000
Labor Costs				15,000	15,000
Profit				5,000	5,000
Subtotal				$429,819	$25,000
Tax on Gross Receipts at 0.5% rate				$2,149	$0
Summary					
Total Nonttax Costs		$400,000			$400,000
Total Profit		$25,000			25,000
Total Tax Costs		$6,968			$2,125
Nominal Tax Rate		0.50%			0.50%
Effective Tax Rate		1.64%			0.50%
Addendum					
Profit as a Percent of Gross Receipts		5.88%			5.88%
Total Taxes as a Percent of Profit		27.87%			8.50%

Franchise or Net Worth Tax

A franchise tax is typically based on net worth (assets less liabilities), equity, assets, or the value of a business' stock. It can be applied to all types of business. This type of tax is sometimes structured like a business license tax or it may be assessed as a certain percentage of the tax base (net worth). Many states have a franchise tax in addition to their corporate income tax, while other states assess this type of tax only on particular sectors such as financial institutions.

Pros:

- It provides a fairly stable source of revenue.
- It can be applied to all types of business.
- It taxes financial measures that businesses are already familiar with.

Cons:

- This tax must be paid even if no profit is realized.
- Annual revenue growth may be weak, depending in part on how it is structured.
- As a company expands its assets, its tax liability automatically increases.
- If assets is used as the base, this tax discriminates against capital.

Restructured Value-Added Tax

Another potential option would be to replace the SBT with a simplified and restructured value-added tax. The SBT uses the additive method to calculate the tax base, which sums up the components that add value to a product such as labor costs and profit. An alternative way to calculate the tax base is to use the subtraction method. Under this method, a business would begin with gross receipts and then subtract the cost of goods and services purchased from other companies and the difference equals the value that a business has added to their goods or services. The advantage of the subtractive method is that gross receipts and the cost of goods sold are common financial measures that businesses already calculate, so this new tax structure would be fairly easy for businesses to calculate. In addition, using the subtractive method would help distinguish a restructured value-added tax from the current SBT. A restructured value-added tax also could be simplified by the elimination of current features of the existing tax, including the excess compensation reduction and the gross receipts reduction.

Pros:

- It would be a relatively broad-based tax that would include all types of business and would treat similarly situated businesses the same.
- Economic activity as measured by value added would be taxed, which would be basing the tax on the benefits-received principle, assuming there is a correlation between economic activity and government services used.
- It would provide a more stable revenue stream than provided by an income tax or the current SBT.
- It would have a neutral impact on the factors of production.

Cons:

- The tax would have to be paid even when no profit was made.
- It may be too similar to the existing SBT.
- Like the SBT, a restructured value-added tax would be unique among the 50 states.

Broad-Based Consumption Tax

Under this alternative tax structure, increases in the retail sales and use taxes would be used to replace the SBT and perhaps other taxes as well. The sales and use taxes for both individuals and businesses would be increased in two ways: 1) by increasing the tax rate, and 2) by expanding the tax base. The major change to the tax base could be to include services, food, prescription drugs, and medical care. Some of the broader versions of this alternative tax structure are referred to as the "Fair Tax". The "Fair Tax" not only expands the base to include most retail activity, but also tends to provide for payments to low- income individuals to help offset or eliminate the regressive nature of this tax.

Pros:

- The tax base would be very broad and therefore the tax burden would be spread among all types of consumption including both goods and services.
- The broad tax base would make the revenue stream more stable than the existing sales and use taxes do and would experience a growth rate more consistent with the rate of economic growth.
- While administration of the sales and use taxes would become more complicated, particularly with payments to low-income individuals, the overall tax system would become less complicated for taxpayers to comply with because a number of other taxes would be eliminated.

Cons:

- The direct tax burden on individuals would be increased and the direct tax burden on businesses would be reduced.
- The State's tax burden would become more regressive because it would be based primarily on consumption and not on income or business activity.
- The tax would place a relatively high tax burden on consumption, which would encourage taxpayers to avoid the tax through increased internet sales, increased purchases from other states, or increased "underground" sales.
- The tax would have a severe negative impact on senior taxpayers.
- The tax could add a substantial tax cost to certain spending categories which are relatively untaxed presently, such as housing and medical goods and services.
- The prebates could be very difficult and costly to administer.

PROPOSED REPLACEMENTS FOR THE SINGLE BUSINESS TAX

A number of organizations and individuals have proposed specific alternative taxes to replace the SBT. Summaries of the most prominent plans that have been proposed so far are presented below.

Business License Fee

The Detroit Regional Chamber of Commerce is recommending that the SBT be replaced with a business license fee. The license fee would be a fixed amount that would increase for each of several sales brackets. The proposed fee schedule is presented in Table 14. Under this proposal, a business's fee would increase from year to year only if its sales increased by enough to push the business into a higher sales bracket. Businesses with sales of $350,000 or less would not have to pay a fee. This proposal would be very simple to administer and very easy for businesses to comply with, but the high level of simplicity would lead to some inequities among taxpayers. The fee as a percentage of business sales would decline within each bracket. For example, in the first sales bracket, the fee as a percentage of sales would fall from 0.3% for businesses with sales of $350,001 to 0.2% for businesses with sales of $500,000. Inequities also would exist between the sales brackets. The fee as a percentage of sales would be lower for businesses in the $20,000,001 to $30,000,000 sales bracket than it would for businesses in the $350,001 to $500,000 sales bracket. The fee schedule also would create an inequity among the larger businesses. Under the proposed fee schedule, the fee would be capped at $1.0 million for businesses with sales in excess of $100.0 million. As a result, the fee would equal a smaller percentage of sales for a firm with $300.0 million in sales compared with a firm having sales of $110.0 million. This plan has been proposed in House Bill 6272.

Table 14

BUSINESS LICENSE FEE SCHEDULE AS PROPOSED BY THE DETROIT REGIONAL CHAMBER OF COMMERCE

Annual Business Sales Brackets	License Fee
$0 - $350,000	$0
$350,001 - $500,000	1,000
$500,001 - $750,000	2,000
$750,001 - $1,000,000	2,500
$1,000,001 - $2,500,000	5,000
$2,500,001 - $5,000,000	7,500
$5,000,001 - $10,000,000	15,000
$10,000,001 - $20,000,000	30,000
$20,000,001 - $30,000,000	50,000
$30,000,001 - $40,000,000	75,000
$40,000,001 - $50,000,000	100,000
$50,000,001 - $60,000,000	150,000
$60,000,001 - $70,000,000	200,000
$70,000,001 - $80,000,000	250,000
$80,000,001 - $90,000,000	300,000
$90,000,001 - $100,000,000	500,000
$100,000,001 & Greater	1,000,000

Source: Detroit Regional Chamber of Commerce.

Michigan Business Activities Tax (Gross Receipts Tax)

The Grand Rapids Area Chamber of Commerce is proposing that both the single business and personal property taxes be repealed and replaced with a Michigan Business Activities Tax. Michigan business activity would be defined as business sales in Michigan. Businesses would be able to deduct the greater of $350,000 or the cost of tangible personal property purchased by businesses for resale, manufacturing, and leasing, and the cost of funds for financial institutions. The tax rate would be a flat rate not to exceed 0.75%. Firms with sales less than $350,000 would be exempt from the tax, but would be subject to an annual fee of $150. It is also proposed that the tax would not replace more than 90.0% of the revenue that would be generated under the single business and personal property taxes and when receipts from this tax exceeded estimates, a tax credit would be granted the following year to return the revenue in excess of the estimate. In addition, this tax would honor any previously granted economic development-related credits against the SBT, but no new credits would be issued. Instead, it is proposed that incentives for economic development be provided through cash grants administered by the Michigan Economic Development Corporation. This proposed tax essentially would be a gross receipts tax and therefore would have the basic advantages and disadvantages of a gross receipts tax; however, it would reduce the negative impact from tax pyramiding. It also would eliminate the costs associated with collecting and complying with the personal property tax. The plan does not address how or if local governments would be reimbursed for their loss of property tax revenue.

Business Income Tax, License Tax, and Personal Property Tax Credit

The Michigan Chamber of Commerce is proposing that the SBT be replaced with a business income tax and a business license tax, and that the personal property tax burden be cut in half through a 50.0% tax credit. The business income tax would have a rate of 3.05% and it would be based on adjusted Federal taxable income. The business license tax would be based on gross receipts and would have a rate of 0.48% on most businesses; wholesale and retail businesses would have a rate of 0.24%. This tax would apply to gross receipts in excess of $350,000. A minimum tax of $150 would be assessed on each business that has employees and the maximum tax on any business would be $2.0 million. In addition, a 50.0% personal property tax credit would be available to all businesses. The Michigan Chamber estimates that this overall tax change would result in a net tax reduction of $500.0 million. If there is not sufficient support in the Legislature to include personal property tax relief in the business tax restructure effort, then the Michigan Chamber would support a modified plan that would exclude the personal property tax credit and reduce the business income tax rate to 1.85% and the business license tax to 0.24% for general businesses and 0.18% for wholesale and retail trade businesses. This plan would have the pros and cons of the business income tax and business license tax.

Business Activities (Value-Added) Tax and Profits Tax

Dr. Gary Wolfram, an economics professor at Hillsdale College and former Deputy State Treasurer, is proposing that the SBT be replaced with the combination of a restructured value-added tax and a profits tax. Under this proposal, businesses would be free to choose which of these taxes they would pay. The value-added tax, or Business Activities Tax, would be based on gross receipts less the cost of inputs purchased from other firms, which is the subtractive method for calculating value added. The Business Activities Tax would include a deduction for capital acquisitions. The tax rate for the Business Activities Tax would be close to 0.75%. The alternative profits tax would be based on business income as defined under the Federal income tax and the tax rate would be 6.0%. In terms of revenue, the goal would be to reduce the revenue collected by these two taxes compared with what the SBT would generate by about $100.0 million. This proposal would have the pros and cons of the value-added and income taxes. In addition, this plan would have a unique situation regarding nexus standards, in that these standards are different for value-added taxes and income taxes, which could complicate the compliance factors and costs.

"Fair Tax"

A group called "Michiganders for the Fair Tax" is supporting a broad-based sales tax to replace the SBT and several other general taxes. The proposed Fair Tax would increase the sales and use taxes by expanding the tax base and increasing the tax rate. The base would be expanded to include such items as food, prescription drugs, medical care, and services. The tax rate would be increased from the current 6.0% to an estimated 8.6%. The supporters of this alternative tax structure estimate that this tax would generate enough revenue so that the following taxes could be eliminated and the overall fiscal impact would be revenue neutral: SBT, individual income tax, personal property tax, and the portion of the State education property tax paid by businesses. In addition, some of the revenue generated from this tax would finance a so-called "prebate", which would be a monthly payment the government would make to low-income individuals and families to compensate them for the sales tax they would have to pay on necessities. It is called a "prebate" because the payment would be intended to cover upcoming sales tax payments on necessities instead of reimbursing the recipients for past payments. The pros and cons associated with a broad-based consumption tax would apply to this tax.

CONCLUDING SUMMARY

The single business tax has been in effect for 30 years, but under current law it will be repealed effective December 31, 2007. While the single business tax generated $1.9 billion in revenue in FY 2004-05, it accounted for only about 13.0% of the total State and local taxes directly paid by businesses operating in Michigan. Other major taxes paid by businesses include property taxes on real and personal property, sales and use taxes, and the unemployment insurance tax. Over the years, changes designed to help ease the tax burden have made the single business tax very complicated and less of a value added tax. In addition, the single business tax has become very unpopular among the business community.

Some of the same issues facing Michigan today were facing Michigan in the early 1970s. The State was suffering through poor economic times and its business tax structure was viewed as part of the problem. To help boost business investment, increase jobs, help create a more stable revenue stream, and solve a large budget deficit, the State's corporate income and franchise taxes, along with a local property tax on business inventories and five other taxes, were repealed and replaced with the single business tax.

Michigan's single business tax burden often is compared with the corporate income tax burden in other states, but this is not a fair or meaningful comparison. The only way to accurately compare the tax burden among states accurately is to include all taxes directly paid by businesses. Using this approach, Michigan's State and local government tax burden on businesses ranks 36th among the 50 states. In addition, business taxes paid in Michigan as a share of overall tax receipts have been edging down over the past 20 years.

Whether the single business tax revenue is replaced in whole or in part by some other type of business tax or a broader tax restructuring agenda is pursued to make additional changes in other business taxes, such as the personal property tax, the task before the Legislature and the Governor is very difficult. The goal of this report is to provide information that will be useful to Michigan's policy-makers as they explore potential changes to business taxes in Michigan. In addition to information on the historical perspective on past changes in Michigan's business tax structure and how Michigan's business tax burden has changed and how it measures up against that of other states, this report provides descriptions and analyses of some of the key alternative business tax structures used by other states, along with key principles for evaluating these alternative taxes. While the task ahead is very challenging, the repeal of the single business tax is presenting a great opportunity to the Legislature and the Governor to take a fresh look at Michigan's business tax structure and identify ways to make it better.