SENATE FISCAL AGENCY
MEMORANDUM

DATE: January 31, 2007

TO: Members of the Senate

FROM: Jay Wortley, Senior Economist
David Zin, Economist

RE: Business Tax Package Passed by the Senate Finance Committee

On January 30, 2007, a package of bills that would create a replacement for the Single Business Tax and reduce industrial personal property taxes was reported by the Senate Finance Committee. These bills were introduced by Senate Nancy Cassis. This business tax proposal has three major components that are contained in the following bills:

- The "Business and Economic Stimulus Tax" would be created in Senate Bill 94 (S-1).
- A "Business Income Tax" would be created in Senate Bill 95 (S-1).
- A property tax exemption for new industrial personal property would be created in Senate Bill 96 (S-1).

The major components of each of these bills are summarized below and estimates of their fiscal impacts are also discussed.

Senate Bill 94 (S-1): The "Business and Economic Stimulus Tax"

This bill proposes to create a "business and economic stimulus tax". The major features of this tax include the following:

Tax Base. The base of this tax would have two components:

1) Gross receipts tax base = gross receipts less purchases from other firms. "Purchases from other firms" would include inventory purchased during the year and capital expenditures.
2) Franchise tax base = a business' assets less their liabilities.

Taxpayers would calculate both tax bases and then would have the choice of assigning weights to these tax bases from a specified list of percentages and would chose the weights that minimize their tax liability. The options for the weights would include 70% on one tax base and 30% on the other tax base, 60%/40%, or 50%/50%. Once a taxpayer chooses the weights that would be most advantageous to them, they would be required to use those weights for three years. At the end of three years, a taxpayer then would be able to change their tax-base weights for the next three years. It appears that in almost all cases, businesses would chose the 70%/30% weights. The chosen weights then would be applied to the two tax bases and the weighted tax bases would be summed to calculate one combined tax base for the business and economic stimulus tax.

Apportionment. For multistate businesses, their combined tax base would be apportioned to Michigan based 100% on the sales factor. The sales factor would equal sales in Michigan during the tax year divided by total sales everywhere during the tax year. The combined tax base would be multiplied by the sales factor to calculate a business' Michigan tax base.

201 N. Washington Square • Suite 800 - The Victor Center • Lansing, Michigan
Telephone: (517) 373-2768 • TDD: (517) 373-0543 • Fax: (517) 373-1986

Tax Rate. The tax rate for the business and economic stimulus tax would be determined by the Department of Treasury, in cooperation with the House and Senate Fiscal Agencies, and the rate would be set so that the revenue generated by the business and economic stimulus in combination with the revenue that would be generated by the business income tax (proposed in Senate Bill 95) would equal $1.56 billion. If the revenue generated by these taxes were to exceed $1.56 billion in a given fiscal year by more than the percentage change in the Detroit Consumer Price Index plus 1%, then the tax rate in the following tax year would be reduced to a level sufficient to lower the combined tax collections back to $1.56 billion, as adjusted each year for the increases in the Detroit Consumer Price Index plus 1%.

Special Provisions for Smaller Firms. This bill would provide the following special tax provisions for two groups of taxpayers:

1) Firms with gross receipts from $350,000 to $15.0 million: Firms falling in this category would have the choice to pay either the gross receipts tax or the business income tax. Once they pick the tax they would want to pay, they would have to pay that tax for three years. A business would be eligible for this special provision as long as they fall in this gross receipts range.
2) Firms with gross receipts less than $350,000: Firms with gross receipts less than or equal to $100,000 would have no tax liability, and firms with gross receipts greater than $100,000 but less than $350,000 would pay a flat amount equal to $100.

Tax Credits. This bill would provide two new tax credits and also adopt a number of credits currently granted through the single business tax.

Michigan entrepreneurial credit.

- This proposed new credit would equal 100% of an eligible business' tax liability.
- To be eligible for this credit in a given year, during the previous year a business would have to have had 1) gross receipts of less than $25.0 million, 2) created at least 20 new jobs, and 3) spent at least $3.0 million in capital investment in Michigan or $5.0 million in Michigan during the previous two years.
- A taxpayer would be able to claim this credit only three times in three consecutive years.
- The credit would have to be paid back if the business were to leave Michigan within five years of claiming this credit.

Personal Property Tax Credit.

- This proposed new credit would equal 10% of the taxes paid on eligible personal property.
- The credit would only be available to industrial personal property acquired during the previous five years.
- The credit would be nonrefundable (the credit could only be used to offset a tax liability), but any unused credits would be able to be carried over and used for up to 10 years. After 2012, firms would no longer claim this credit due to the personal property tax exemption proposed in Senate Bill 96.

Credits Retained From The Single Business Tax. Certain tax credits currently available under the single business tax including the Michigan next energy credits, Michigan Economic Growth Authority (MEGA) credits, Renaissance Zone exemption, and the Michigan Early Stage Investment tax vouchers, would be retained under this proposed new tax.

Disposition of Revenue. The revenue generated by this tax would be deposited into the General Fund.

Tax on Insurance Companies. Insurance companies would not be subject to the proposed business and economic stimulus tax, but would continue to be taxed as they are under current law. Currently, insurance companies pay a tax equal to 1.0735% of gross direct premiums received plus certain receipts, less credits for payments they make into certain industry guaranty funds. As under current law, this tax on insurance companies would continue to be in lieu of all other privilege or franchise fees, income taxes, and other taxes imposed by the State, except for taxes on real and personal property.

Senate Bill 95 (S-1): Business Income Tax

This bill would create a business income tax. All businesses with gross receipts in excess of $15.0 million would be subject to the business income tax in addition to the business and economic stimulus tax. The major features of this proposed tax include the following:

Tax Base. The base of this tax would start with business income, which would be essentially a business' Federal taxable income, and then certain adjustments would be made before the base is apportioned to Michigan. These adjustments that a business would make to their Federal taxable income before apportioning their tax base include:

- adding interest and dividend income from securities and obligations from other states,
- adding all taxes paid under this tax that were deducted in calculating Federal taxable income,
- adding any carryback or carryover of a net operating loss if deducted in arriving at Federal taxable income.

After the tax base is apportioned to Michigan, a few other adjustments dealing with business and nonbusiness losses would be made, including deductions for business losses carried over from the single business tax.

Apportionment. For multistate businesses, their tax base would be apportioned to Michigan based 100% on the sales factor. The sales factor would equal sales in Michigan during the tax year divided by total sales everywhere during the tax year.

Tax Rate. The rate of the business income tax would be 1.2%.

Special Provisions for Smaller Firms. This bill would provide the following special tax provisions for two groups of taxpayers:

1) Firms with gross receipts from $350,000 to $15.0 million: Firms falling in this category that chose to pay the gross receipts tax under the business and economic stimulus tax as proposed in Senate Bill 94, would be exempt from this tax.
2) Firms with gross receipts less than $350,000: Firms with gross receipts less than or equal to $350,000 would have no tax liability and would not have to file a return.

Disposition of Revenue. The revenue generated by this tax would be deposited into the General Fund.

Insurance Companies. Insurance companies would be exempt from the business income tax.

Senate Bill 96 (S-1): Personal Property Tax Exemption

This bill would exempt new industrial personal property from taxation. This exemption would apply to such property taxes as the State education tax, local 18-mill school tax, local government property taxes, and the industrial facilities tax. This exemption would begin December 31, 2007. Because this exemption would apply to new industrial personal property purchased after 2007, this exemption would eventually eliminate all industrial personal property from property taxes.

Fiscal Impact

Senate Bill 94 and Senate Bill 95: New Business Taxes. The bills are expected to increase General Fund revenue by approximately $1.56 billion in the initial year of the tax. The bills do not specify if the $1.56 billion is to be generated during the first full tax year in which the bills are in effect, or for FY 2007-08, the first fiscal year affected by the bills. The business income tax under Senate Bill 95 is expected to generate approximately $300.0 million in the first 12-month period the bill is in effective. The remaining $1.26 billion would be generated under the tax proposed in Senate Bill 94. An estimate of what the tax rate would have to be in order to generate that amount of revenue has not yet been completed.

Revenue from the tax would be limited in certain future years, such that the combined revenue from the taxes would not exceed the $1.56 billion. However, this limitation would only apply for tax years where in the previous fiscal year the revenue from the taxes in the two bills exceeded the $1.56 billion amount, as adjusted for the increase in the Detroit Consumer Price Index plus 1%. If the amount were exceeded, the rate for the tax in Senate Bill 94 would be altered in the next tax year so that the combination of the two bills would only generate $1.56 billion. As with the initial establishment of the rate, no time frame (such as tax year or fiscal year) is identified in the bill to indicate when the $1.56 billion is to be generated. Furthermore, the language regarding the rate adjustment would appear to also include insurance tax revenue within the limit, while it is apparently excluded from the computation when the rate is to be initially set.

Certain provisions in the bills suggest the tax rate for the tax in Senate Bill 94 is likely to decrease even if economic growth does not require a rate reduction. The value of the credit for personal property taxes levied on property acquired in the previous five years is expected to decline due to the effect of the exemption contained in Senate Bill 96. The rate on the tax in Senate Bill 94 is also expected to decline as growth occurs in the business income tax contained in Senate Bill 95, because the combined revenue from the two bills is limited. As a result, the business income tax is expected to represent a larger share of business tax revenue over time, which is expected to increase the volatility of both tax receipts and the frequency of adjustments to the tax rate specified in Senate Bill 94.

Senate Bill 96: Personal Property Tax Exemption. The property tax exemption on new industrial personal property proposed in Senate Bill 96 would reduce property taxes by an estimated $88.0 million in 2008. Of this loss in revenue, local government property taxes would be reduced an estimated $47.0 million, revenue from the 18-mill local school tax would be reduced $30.0 million and the State education tax revenue would decline $10.0 million. The loss in the 18-mill local school property tax revenue would increase the State's School Aid Fund (SAF) expenditures in order to maintain guaranteed per pupil funding amounts and the loss of State education tax revenue would reduce SAF revenue, for a total impact on the SAF of an estimated $41.0 million. Given that this exemption applies to all new industrial personal property acquired after December 31, 2007, the revenue loss of this proposed credit over time, as each additional year of new industrial personal property is added to this exemption, the cost of the credit would grow significantly. In 2009 and 2010, the overall loss in property tax revenue due to this personal property tax exemption would total an estimated $166.0 million and $236.0 million, respectively. At the present time, it is estimated that total personal property taxes generated by industrial personal property equal about $800 million.

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c: Gary S. Olson, Director
Ellen Jeffries, Deputy Director

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