SENATE FISCAL AGENCY
MEMORANDUM

DATE: March 28, 2007

TO: Members of the Senate

FROM: Jay Wortley, Senior Economist
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RE: Business Tax Package As Reported by the Committee of the Whole on March 27, 2007

On March 27, 2007, the Committee of the Whole reported a package of bills that would create a replacement for the Single Business Tax and reduce industrial and commercial personal property taxes. 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-6 as amended).
- A "Business Income Tax" would be created in Senate Bill 95 (S-4).
- 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-6 as amended): 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 be based on gross receipts less purchases from other firms. "Purchases from other firms" would include inventory purchased during the year and capital expenditures.

Tax Rate. The tax rate for the business and economic stimulus tax would equal 0.54%. 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 1.0%, 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 1.0%.

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.

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.

<u>Tax Credits</u>. This bill would provide three new tax credits and also adopt a number of credits currently granted through the single business tax.

<u>Michigan Entrepreneurial Credit</u>

- 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 (which would be adjusted annually for inflation), 2) created at least 20 new jobs, and 3) spent at least $2.0 million in capital investment in Michigan.
- A taxpayer would be able to claim this credit not more than five times in five consecutive years.
- The credit would have to be paid back if the business were to leave Michigan within five years of claiming this credit.

<u>Personal Property Tax Credit</u>

- This proposed new credit would equal 25.0% of the taxes paid on eligible personal property.
- The credit would be available to industrial (excluding industrial facilities taxes) and commercial 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, this credit would only effectively apply to commercial personal property because industrial personal property that would otherwise be eligible for this credit would be completely exempt from taxation due to the personal property tax exemption proposed in Senate Bill 96.

<u>Smoking Ban Tax Credit</u>

- This proposed new credit would equal 10.0% of the of an eligible business' tax liability.
- Eligible businesses would those restaurants that impose a smoking ban during the entire tax year for which the credit is claimed.
- The credit would be nonrefundable and unused credits would not be transferable or carried over to future tax years.

<u>Credits Retained From The Single Business Tax</u>. 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.

<u>Disposition of Revenue</u>. 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.

Combined Reporting. The bill would make a number of changes in the way businesses that are controlled by common entities and/or operate in conjunction with each are taxed. The bill would require unitary business groups, defined as entities related through common ownership whose business activities are integrated with, are dependent upon, and contribute to each other, to file as a single taxpayer. Certain exclusions would apply to members of a unitary group whose operations are 80.0% or more outside of the United States. Currently, the Single Business Tax makes no provisions for filing on a unitary basis, although (subject to current requirements) such a taxpayer might request to file a consolidated return.

The bill would also allow certain taxpayers meeting ownership and control requirements to file as a consolidated taxpayer group. Under current law, only taxpayers with Michigan nexus may be included in a consolidated group. The Department of Treasury generally approves requests to file as a consolidated group when taxpayers meet the qualifications, and may request that taxpayers file on such a basis. The bill does not provide the Department the ability to require consolidated filing and would require the Department to approve any election that met the requirements in the bill. The bill's requirements are considerably broader than under current law and would allow taxpayers with no Michigan nexus (or even no U.S. operations) to be included in the tax base and considered for apportionment purposes.

Senate Bill 95 (S-4): 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;
- deducting dividends and royalties from foreign persons to the extent they are included in Federal adjusted 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 1.5%.

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

1) Firms with gross receipts greater than $350,000 but not more than $15.0 million: Firms 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 in this category 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.

Combined Reporting. The bill would apply the same standards regarding unitary business returns and consolidated tax groups as those in Senate Bill 94.

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 $1.43 billion in the initial year of the tax. The business income tax under Senate Bill 95 is expected to generate approximately $304.3 million during tax year 2008, which would include portions of FY 2007-08 and FY 2008-09. The remaining $1.12 billion during the first full tax year would be generated under the tax proposed in Senate Bill 94.

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 limit, adjusted annually for inflation plus 1.0%. Beginning with FY 2008-09, if the revenue from the taxes in the two bills exceeded the $1.56 billion amount, as adjusted annually for the increase in the Detroit Consumer Price Index plus 1.0%, 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 the $1.56 billion amount, as adjusted, in the next fiscal year. The rate adjustment computation would exclude insurance tax revenue from the limit.

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. Furthermore, when rate adjustments occur, the adjustments are made on a tax year basis to produce a revenue result on a fiscal year basis. As a result, rate adjustments would need to adjust in the remaining nine months of the fiscal year for the 12 months of excess revenue collection in the prior fiscal year plus three months of excess collection in the current fiscal year. As a result, downward rate adjustments will essentially overcompensate for the excess revenue collections and not only push the rate on the tax in Senate Bill 94 lower but likely lower revenue below for $1.56 billion (inflation-adjusted) limit for a number of subsequent fiscal years.

At this point it is unclear how the unitary and consolidated taxpayer provisions would affect revenue. The unitary provisions under Senate Bill 94 are likely to have limited effect because increases in the tax base created by the unitary filing would be offset by changes in the apportionment formula due to the fact that both the tax base and the apportionment are essentially based on sales. However, because the economic activity used by the apportionment calculation and the tax base differ under the business income tax in Senate Bill 95, the unitary requirements could increase revenue above what would occur absent any provisions requiring unitary filing. The effect of the consolidated filing options is likely to reduce revenue by an unknown amount because consolidated returns tend to result in lower liabilities for the taxpayer group (otherwise the group would likely not elect to file as a consolidated group). The broader standard for allowing consolidated filing under the bills would thus likely result in a greater number of taxpayers filing consolidated returns than under current law and would lower the revenue estimates from those presented above.

<u>Senate Bill 96: Personal Property Tax Exemption</u>. 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 $800.0 million.

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