## SENATE FISCAL AGENCY
## MEMORANDUM

**DATE:** December 10, 2007

**TO:** Members of the Senate

**FROM:** David Zin, Economist

**RE:** House Bill 5408 (Public Act 145 of 2007), Michigan Business Tax Surcharge and Other Tax Changes - **REVISED**

On December 1, 2007, the Michigan Legislature sent House Bill (H.B.) 5408, which amended the Michigan Business Tax (MBT), to the Governor to become Public Act 145 of 2007. While the impetus behind the bill was to replace revenue lost by repealing the extension of the use tax to certain services, the bill also makes a number of additional changes to the MBT. Overall, the MBT provisions in House Bill 5408 are estimated to increase revenue by something slightly less than $489.6 million in FY 2007-08 and $746.3 million in FY 2008-09. The net effect on the budget, when combined with repealing the extension of the use tax to certain services, would be to reduce FY 2007-08 revenue by at least $124.2 million and FY 2008-09 revenue by at least $5.0 million.

### Background

As part of the enacted FY 2007-08 budget, the State made several changes to the Michigan income tax and the use tax in order to generate enough revenue to support the desired level of appropriations. House Bill 5194 (Public Act 94 of 2007) increased the individual income tax rate from 3.9% to 4.35% effective October 1, 2007, while H.B. 5198 (Public Act 93 of 2007) expanded the use tax to a number of services, effective December 1, 2007. The use tax expansion was expected to generate $613.8 million in FY 2007-08, of which $204.6 million would be deposited in the School Aid Fund (SAF), and $751.3 million in FY 2008-09, of which $250.4 million would be deposited into the SAF.

After its passage, H.B. 5198 generated substantial criticism and both the Michigan House of Representatives and the Michigan Senate introduced bills to repeal all or some of the changes to the use tax before they took effect. In the meantime, the Michigan Legislature approved virtually the entire FY 2007-08 budget, appropriating essentially all of the revenue to be raised as a result of H.B. 5198. As a result, any repeal of the use tax expansion would require either additional budget reductions or an alternative source of revenue. House Bill 5408, as passed by the House, was an attempt to provide an alternative source of revenue.

### House Bill 5408, As Enacted

House Bill 5408, as enacted, repeals the use tax expansions adopted in H.B. 5198 and makes a number of changes to the Michigan Business Tax. The changes include:

1. Modifying the definition of both business income and gross receipts, as applied to individuals, estates, and other estate-related entities.
2. Expanding the definition of purchases from other firms to include certain rental and royalty payments paid by theaters.

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3. Expanding the number of insurance companies eligible to receive the MBT compensation credit and expanding the credit to financial institutions.
4. Imposing a new surcharge on taxpayers based on liability before credits.
5. Reducing the amount that can be claimed as a credit under the compensation credit, the investment tax credit, the research and development credit.
6. Creating several new credits, including one for a motorsports entertainment complex and one for certain costs incurred by beverage manufacturers or distributors.
7. Expanding several existing credits, including a credit for a qualified large retailer and the credit new motor vehicle dealers may claim against the cost of acquiring motor vehicle inventory.
8. Expanding the taxes eligible for inclusion when computing credit for property taxes paid on personal property.
9. Increasing the amount of MBT revenue earmarked to the School Aid Fund.
10. Modifying the limits on the amount of revenue the tax may generate, expanding those limits past FY 2009-10, and modifying the distribution of any revenue exceeding the limits.

In addition to the changes to the MBT, the bill also repeals section 3d of the Use Tax Act. Section 3d was created in H.B. 5198 and expanded the use tax to a new array of services effective December 1, 2007.

**Business Income and Gross Receipts Definitions**

The bill modifies the definition of both business income and gross receipts for individuals and certain estate-related entities. The original language adopted with the MBT suggested that certain types of casual transactions, such as selling a primary residence or selling certain retirement assets to purchase a retirement annuity, would generate gross receipts and/or business income that would be taxable under the MBT. The changes in H.B. 5408 would essentially restrict business income and gross receipts included under the MBT to income and/or receipts that are part of the regular course of a taxpayer's trade or business.

Revenue from activities not regularly part of a taxpayer's trade or business was not included in the revenue estimates for the MBT. As a result, the change does not affect the revenue estimates. How much revenue would have been generated if the changes had not been made is unknown.

**Exclusion of Rental and Royalty Payments by Theaters**

House Bill 5408 also allows theater owners to deduct from gross receipts film rental or royalty payments made to film distributors and/or film producers. For the 2009 tax year, the deduction is limited to 50.0% of the payments, and then increases to the full amount in 2010 and later. The deduction is expected to reduce revenue by $0.6 million during FY 2008-09.

**Expansion of the Compensation Credit**

The MBT offers a credit for a portion of the compensation paid in the state. Insurance companies also may claim the credit unless they have made payments to certain insurance related organizations: the Michigan workers' compensation placement facility, the Michigan basic property insurance association, the Michigan automobile insurance placement facility, and the property and casualty guaranty association. The MBT already allows a 100% credit for these amounts. House Bill 5408 would allow taxpayers who have made payments to these organizations to claim the compensation credit. The expansion is forecasted to reduce MBT revenue by $2.5 million during FY 2007-08 and $4.1 million in FY 2008-09.

The bill also expands the compensation credit to financial institutions. Financial institutions essentially pay a net worth tax under the MBT, rather than the business income and gross receipts taxes levied upon other businesses. As originally enacted, the MBT did not allow financial institutions to claim the compensation credit. A more precise estimate of the cost of the expansion is still underway, but it appears the expansion would reduce MBT revenue by between $3.0 million and $6.0 million in FY 2007-08 and between $5.0 million and $10.0 million in FY 2008-09.

**Surcharge on Tax Liability**

House Bill 5408 imposes a surcharge on taxpayer liability for most taxpayers. Insurance companies are excluded from paying the surcharge, as are financial institutions that only exercise trust powers. Most taxpayers will pay a 21.99% surcharge, computed on the tax liability before any credits are applied, although those financial institutions not exempted from the surcharge will face a surcharge with a higher rate. For those financial institutions, the surcharge rate is 27.7% for the 2008 tax year and then falls to 23.4% in subsequent years. The maximum surcharge paid by any taxpayer is limited to $6.0 million. The surcharge is expected to generate $505.3 million during FY 2007-08 and $772.7 million during FY 2008-09, although a small reduction to this amount, due to taxpayers with fiscal years that differ from the calendar year, is described later.

The MBT offers numerous credits, although the compensation credit and the investment tax credit must be computed before other credits are computed. The combination of these credits may not exceed a specified proportion of the liability before the credits. Furthermore, the credit for eligible research and development expenses is also limited so that the combination of the credit and the compensation and investment tax credits, also may not exceed a specified proportion of the liability before any credits are applied. However, when computing these limits, H.B.5408 specifies that the limits are computed on the tax liability before credits AND before the surcharge. As a result, these three credits are not able to reduce any additional liability created by the surcharge.

House Bill 5408 also contains a provision for repealing the surcharge. If during any of the three calendar years before 2017, Michigan personal income grows from the level in the preceding year, then the surcharge will be eliminated effective January 1, 2017. The bill does not adjust the personal income growth for inflation. Michigan personal income data are available back through 1929 and the only time Michigan personal income did not increase for three consecutive years was during four consecutive years of decline from 1930 to 1933. Rather than eliminating the surcharge for tax years beginning on or after January 1, 2017, the bill eliminates the surcharge as of January 1, 2017, so that some taxpayers will have the surcharge prorated in those years.

Because the tax on businesses changes from the Single Business Tax (SBT) to the MBT in the middle of some taxpayers' fiscal years, some taxpayers will have partial year liabilities under each tax. The surcharge will apply only to the portion of a taxpayer's fiscal year that the taxpayer has a liability under the MBT. As a result, the revenue generated by the surcharge is reduced by $3.1 million during FY 2007-08 and $6.4 million during FY 2008-09.

**Credit Reductions**

During the 2008 tax year, H.B. 5408 lowers the share of Michigan compensation that can be claimed as a credit under the compensation credit from 0.37% to 0.296% (the 0.37% rate is restored for tax years 2009 and later). Similarly, the bill lowers the share of investment expenditures that can be claimed for an investment tax credit from 2.9% to 2.32% in tax year 2008 (again, the 2.9% rate is restored for tax years 2009 and later). As mentioned earlier, several credits under the MBT are limited to a specified percentage of liability before credits (and before the surcharge). House Bill 5408 lowers the share of liability that the combination of the compensation credit and the investment tax credit can offset from 65.0% to 50.0% for tax year 2008 and 52.0% in tax years 2009 and later.

Similar changes are made to the research and development credit, with the share of expenses eligible for the credit lowered from 1.9% to 1.52% for tax year 2008 (the 1.9% rate is restored for tax year 2009 and later). However, the amount of liability that can be offset by the credit, combined with the compensation credit and the investment tax credit, is permanently lowered from 75.0% to 65.0%.

The revenue estimate shown above for the surcharge includes the impact of reducing the compensation credit, investment tax credit, and research and development credit.

**New Credits**

Two new credits are created under the bill, one for a motorsports entertainment complex and another for a distributor or manufacturer who originates a deposit under the Michigan's bottle deposit law. It appears that the Michigan International Speedway would be the only entity that would qualify for either the original or the new motorsports entertainment credit, and the new credit would allow a credit against necessary expenditures incurred to ensure traffic and pedestrian safety while hosting motorsports events. For the 2009 tax year only 50.0% of the expenditures would be eligible for the credit, while 100% would be eligible in tax years 2010 and later. The credit is also refundable. The bill does not define "necessary expenditures" nor place any cap on the expenses eligible for the credit or the total amount of the refundable credit.

House Bill 5408 creates a credit for distributors or manufacturers who originate deposits under the State's bottle deposit law based on a percent of the expenses they incur complying with the law (M.C.L. 445.571 to 445.576). If a surcharge is imposed under the MBT, then the credit equals 30.5% of the expenses, otherwise only 25.0% of the expenses are eligible. The credit is not refundable and unused amounts can not be carried forward. The bill does not define what constitutes expenses incurred to comply with the bottle deposit law nor limit the credit by any amount other than the taxpayer's liability.

The new motorsports entertainment credit is predicted to reduce FY 2008-09 revenue by $1.9 million. This estimate may understate the actual impact because of the incentive effects under the way the credit is structured. The bottle deposit credit is expected to reduce revenue by $3.1 million in FY 2007-08 and $5.0 million in FY 2008-09. As with the motorsports entertainment credit, the actual impact may be substantially larger because limited information is available on which taxpayers would qualify, how much their expenses are, and the way any limits on the credit are structured.

**Expanded Credits**

Two credits under the MBT are expanded:  one for a large retailer and the other for new motor vehicle dealers.  Meijer appears to be the only taxpayer that would qualify for the large retailer credit, which is permanently increased from 0.535% of the taxpayer's Michigan compensation to 1.0%.  The maximum credit that can be claimed in a year is increased from $4.5 million to $8.5 million.

Under the MBT, new motor vehicle dealers may claim a credit of 2.0% of the amount paid to acquire new motor vehicle inventory, up to a maximum credit of $10,000 per taxpayer.  The amount paid is not limited to the interest paid to acquire the inventory, but also includes the principal (i.e. the cost of the vehicle).  House Bill 5408 lowers the share of expenses that can be claimed for the credit from 2.0% to 0.25%.  However, the $10,000 cap on the credit is eliminated.

The change to the large retailer credit would reduce revenue by $4.0 million each year, while the magnitude of the reduction in revenue from the motor vehicle dealer credit is unknown and possibly substantial.

**Personal Property Tax Credits**

The MBT allows a credit against certain taxes levied on personal property, and the share of taxes eligible for the credit depends on the type of taxpayer.  House Bill 5408 adds taxes levied under M.C.L. 207.1 to 207.21 to the list of taxes that may be included when computing the credit.  These property taxes are state assessed taxes against certain public utilities, including rail transportation and telephone/telegraph companies.  The original estimates for MBT revenue were based on the assumption that these taxes were included under the credit.  As a result, the change does not change the revenue estimates.  It is unknown how much the estimate would have needed to be increased if the changes had not been made.

**Earmarked Revenue for the School Aid Fund**

As originally enacted, the MBT earmarked revenues to the School Aid Fund to hold it harmless for certain property tax exemptions adopted concomitantly with the MBT.  The use tax expansions to services adopted in H.B. 5198 would have resulted in approximately $204.6 million in revenue to the SAF during FY 2007-08 and $250.4 million during FY 2008-09.  Repeal of the use tax expansion thus reduced revenue that would have been deposited into the SAF, revenue that had been appropriated under the SAF appropriations.  In order to hold the SAF harmless for the loss of revenue due to the repeal of the use tax expansions, the bill increases the earmarked MBT revenue by $205.0 million in FY 2007-08 and $250.0 million in FY 2008-09.  As a result, the total amount of MBT revenue earmarked to the SAF increases to $341.0 million in FY 2007-08 and $729.0 million in FY 2008-09.

**Modifications to the MBT Revenue Limits**

As originally enacted, the MBT limited the amount of revenue the MBT could generate in FY 2007-08 through FY 2009-10. The FY 2007-08 limit was established at a fixed amount and then essentially allowed to grow at a rate equal to one percentage point more than the growth in Michigan personal income during the fiscal year. No limit was placed on the growth for fiscal years after FY 2009-10. If the limit was exceeded by more than $5.0 million, then the excess revenue would be split equally between refunds to taxpayers and the Budget Stabilization Fund (BSF), otherwise all of the excess was directed to the BSF. Any refunds were to be prorated across taxpayers according to the MBT payments they had made during the prior fiscal year.

House Bill 5408 makes substantial changes to virtually all aspects of the revenue limit. The FY 2007-08 cap is increased to an amount equal to $2,619.1 million increased by 0.75 percentage points more than the growth in the U.S. consumer price index between FY 2007-08 and FY 2006-07. The FY 2008-09 limit is $3,051.5 million increased by 1.5% more than the growth in the U.S. consumer price index between FY 2008-09 and FY 2006-07. For FY 2009-010 and later years, the limit equals the preceding year's limit increased by 0.75% more than the growth rate in the U.S. consumer price index during the current fiscal year.

House Bill 5408 also alters the distribution of any revenue over the limit. Any overage less than $5.0 million is still directed to the BSF, but if the limit is exceeded by more than $5.0 million then the excess is split with 60.0% being refunded to taxpayers and 40.0% directed to the BSF. Any required refunds are to be prorated according to the amount of credits claimed under the combination of the compensation credit, the investment tax credit, and the research and development credit.

**Effect on the State Budget**

Although several components that will reduce revenue under H.B. 5408 are still unknown, the changes to the MBT will likely increase State revenue by $489.6 million in FY 2007-08 and $741.3 million in FY 2008-09. The repeal of the use tax expansion to selected services will reduce revenue by an estimated $613.8 million in FY 2007-08 and $751.3 million in FY 2008-09. As a result, the net effect of H.B. 5408 is expected to reduce revenue by at least $124.2 million in FY 2007-08 and $5.0 million in FY 2008-09. Due to the nature of the earmarking of MBT revenue, the SAF will not experience any change in revenue under the bill. All of the bill's impact would affect General Fund revenue.

If you have any questions, please contact our office at 3-2697.

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