PRESIDENT BUSH'S TAX CUT PROPOSAL

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Although tax bills must originate in the U.S. House of Representatives, Senators Phil Gramm of Texas and Zel Miller of Georgia have introduced S.35, a bill reflecting President Bush's campaign promise to change Federal tax laws. The bill proposes numerous changes in the Federal individual income tax, including changes in marginal tax rates for all taxpayers, an additional deduction for married couples in which both spouses work, an expansion of education individual retirement accounts (IRAs), a phased-in increase in the child tax credit, and certain incentives designed to increase charitable contributions. The bill also proposes a phase-out of Federal estate and gift taxes and recommends eliminating the 2004 expiration of the current research tax credit. Some of these provisions would affect Michigan tax revenues. A brief summary of those impacts is provided below and a detailed Senate Fiscal Agency analysis of the impact is scheduled to be released later in March 2001.

Proposed Changes

Income Tax. The current Federal individual income tax employs five tax brackets to define the levels of taxable income subject to different marginal tax rates. President Bush's tax cut proposal would change both the taxable income levels where brackets begin and the marginal tax rates for each bracket. Currently, the marginal tax rates range from 15% to 39.6%, with higher levels of taxable income facing higher marginal tax rates. President Bush's proposal, once fully phased-in for 2006, would reduce the number of brackets from five to four, and the marginal tax rates would range from 10% to 33%. Currently, the levels of taxable income that define each bracket are adjusted each year for inflation. President Bush's proposal would eliminate these adjustments until after 2006.

"Marriage Tax". Under current law, married couples in which both spouses work face a "marriage tax". The "marriage tax" results from the combined income of the couple facing a higher marginal tax rate than would occur if each spouse were able to file as an unmarried individual. President Bush's tax cut proposal would provide an additional deduction to married couples in this situation. The deduction would be limited to the lesser of 10% of the earned income of the spouse with the lower earned income or 10% of an applicable limit. The applicable limit would rise from $6,000 in 2002 to $30,000 in 2006. As a result of this deduction, married couples in which both spouses work would be able to deduct up to $3,000 ($600 in taxes for a married couple in the proposed 20% marginal tax bracket) from their taxable income once the change was fully phased-in. The deduction would be available to all married individuals filing joint returns, not just those taxpayers who are able to itemize deductions. The proposal would not adjust the applicable limit amount each year for inflation.

Education IRA. Under current law, taxpayers may contribute up to $500 per year per beneficiary to an education IRA to reimburse certain postsecondary education expenses. With an education IRA, the income is taxed in the year the contribution is made while taxes on the interest earnings are deferred until withdrawals are made. Withdrawals are taxed at the beneficiary level, where the income usually faces a lower marginal tax rate. President Bush's proposal significantly would expand the provisions of education IRAs. The contribution limit would be increased to $5,000 by 2006, and eligible expenses would be expanded from postsecondary expenses to include also elementary and secondary education expenses, whether incurred at a public, private or religious institution, as well as expenses associated with home schooling.

Child Tax Credit. Currently, many taxpayers with children are eligible for a nonrefundable credit of up to $500 per child. For certain taxpayers with higher incomes the credit is reduced or eliminated. President Bush's proposal would phase-in an increase in the credit to $1,000 by 2006, as well as changes that would preserve more of the credit for higher income taxpayers. The proposal also would eliminate a provision that reduces or eliminates the credit for certain taxpayers who must pay taxes under the alternative minimum tax.

Charitable Contributions. Under the current Federal individual income tax, taxpayers who are eligible to itemize deductions may subtract a portion of charitable contributions from taxable income. President Bush's proposal would change the deduction so taxpayers who do not itemize also could claim it. For nonitemizers, the percentage of allowable deductions that may be claimed would increase from 20% in 2002 to 100% in 2006. The plan also would eliminate certain penalties on IRA withdrawals if those withdrawals were used for qualified charitable contributions.

Estate Tax. President Bush's tax cut plan would begin a phase-out of Federal estate and gift taxes. Under current law, estates are effectively exempted from the tax if the taxable value of the estate is below $675,000. Current law will increase that limit to $1,000,000 by 2006, although certain estates are already exempt up to a value of $1.3 million. The President's proposal would retain these exemptions, but would apply lower tax rates to all brackets. Initially, all tax rates in all brackets would be reduced by five percentage points in 2002 and 2003, but the reduction would increase to 40 percentage points by 2008. After 2008, the proposal would repeal the Federal estate and gift tax. The Senate Fiscal Agency has a forthcoming report estimating the effect of the Federal estate tax changes on Michigan tax revenues.

Corporations. President Bush's tax cut plan would increase the amount that corporations may deduct for contributions for charitable giving from 10% to 15% of taxable income, and eliminate the sunset on a credit for certain research activities. Under current law, the credit for increasing research activities is to expire in 2004.

Impact on Michigan. Michigan's income and estate taxes are linked, by varying degrees, to the Federal income and estate taxes. As a result, the changes proposed by President Bush would affect the amount of revenue these Michigan taxes generate. Following are brief descriptions of the linkages between the Federal and Michigan income and estate taxes, including the components of the Bush plan that would affect Michigan's taxes.

Income Tax. Michigan's income tax uses Federal adjusted gross income (AGI) as its starting point for calculating taxable income. Therefore, any of President Bush's proposed changes to the Federal income tax that would change AGI would have an impact on Michigan's income tax. Under S. 35, the only component that would change AGI is the deduction designed to reduce the so-called "marriage tax". Therefore, if a working married couple would qualify for a marriage penalty deduction on their Federal return, they also would automatically realize this deduction on their Michigan income tax calculation because the deduction would be included in their AGI. If this component of the Bush plan were to become law, Michigan lawmakers would face a policy issue. Unlike the Federal income tax, Michigan's income tax does not currently create a marriage penalty on married couples who both work. The marriage penalty at the Federal level results from the progressive rate schedule, under which taxpayers face a higher average tax rate as their taxable income increases. Michigan's income tax rate is not progressive, but is a single flat rate, currently at 4.2%. All Michigan taxpayers, no matter what their taxable income, are taxed at the same rate. As a result, while this proposed marriage penalty deduction would help create a more equitable tax structure for the Federal income tax, it would create a less equitable tax structure for Michigan's income tax by creating a "marriage subsidy". To address this equity issue, the Legislature could enact a law to exclude the Federal marriage penalty deduction from AGI when the Michigan income tax is calculated.

Estate Tax. Michigan's estate tax is directly linked to the Federal estate tax. The Federal estate tax allows a credit for State death tax liabilities, up to some maximum level. As in most other states, Michigan's estate tax liability is equal to whatever maximum allowable Federal credit can be claimed by the decedent's estate. Therefore, any changes in the Federal estate tax that altered the credit for state death taxes would affect the amount of revenue Michigan collects from its estate tax. As described above, President Bush's plan would phase out the Federal estate tax from 2002 to 2008, and as a result, Michigan's estate tax also would be eliminated over this time period. In FY 2000-01, the estate tax is expected to generate $190 million, and all of it is earmarked to the General Fund/General Purpose budget.