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Reforming Michigan's Tax Structure

Issue

Michigan's current system of business taxes, particularly the Michigan Business Tax (MBT), is highly complex, and includes an intricate web of incentives, credits, and deductions that unfairly favor some businesses or industries over others, hurts Michigan businesses, and hampers job growth. Replacing the MBT with a simple, fair, and efficient Corporate Income Tax will even the playing field and enable all businesses and industries, large and small, to grow and create jobs.

Proposal

The Governor recommends eliminating the MBT and replacing it with a flat 6% Corporate Income Tax. In general, only "C" corporations would be subject to the tax. Other businesses, such as partnerships, sole-proprietorships, and most limited liability companies would be exempt. These companies already pay tax on business profits under the individual income tax. Furthermore, the Corporate Income Tax would eliminate the old system of tax credits and deductions, retaining only a single credit targeted towards small businesses. The Governor proposes that existing commitments made to businesses under the old tax structure be honored, but stops this spending practice going forward unless annually appropriated and reviewed for effectiveness.

The Governor also proposes changes to the Income Tax Act to make it as simple, fair, and efficient for individuals as the Corporate Income Tax is for businesses. The individual income tax rate will be reduced from 4.35% to 4.25% on October 1, 2011, as scheduled. The Governor recommends broadening the individual income tax base in order to capture all individual income earned in the state regardless of source and eliminating all credits and deductions related to the individual income tax, with the exception of the personal exemption, homestead property tax credit, and a few other subtractions.

Michigan is one of only three states in the nation that exempt most or all pension income from state income tax. Michigan's pension exemption and other tax preferences targeted towards seniors result in an extremely inequitable tax burden distribution across senior and non-senior taxpayers. An example from actual tax return data highlights this problem. Currently a senior couple with household income of $59,000, made up mainly of pension income and social security, could have no tax liability and actually receive a check of several hundred dollars back from the state. At the same time, a non-senior working couple with children, whose household income is $10,000 less, could have to pay over one thousand dollars in Michigan income tax.

The pension exemption also creates inequities between seniors, as those with income from work are currently taxed, while those with income from a pension are not. Under the Governor's tax plan, pension income will be taxed just like other income, but social security benefits, which accrue to all seniors, will continue to be exempt from state income tax.

Eliminating the MBT and moving Michigan to a 6% Corporate Income Tax will result in revenue loss of approximately $1.8 billion on a full-year basis. Restructuring the Income Tax Act will offset this loss, streamline the tax codes, and make the shift to the Corporate Income Tax essentially revenue neutral beginning in fiscal year 2013.

Proposal Details

- ***Corporate Income Tax (CIT)***

  - **6%** of the CIT tax base after allocation or apportionment.
  - Honors existing commitments for tax credits made to businesses through signed agreements under the old tax structure, which total $500 million in fiscal year 2013. (Note: These commitments will be honored in companion legislation.)
  - Persons subject to the CIT are limited to C corporations and limited liability companies that have chosen to be taxed as C corporations for federal tax purposes. Unlike the MBT, partnerships (including limited liability companies taxed as partnerships), S corporations, trusts, and individuals are not subject to the CIT.
  - Nexus standards from the MBT are retained. That is, an out-of-state taxpayer will be subject to the CIT tax if that taxpayer has a physical presence in Michigan or actively solicits sales in this state and has Michigan sales of $350,000 or more, subject to federal restrictions.
  - The CIT tax base is federal taxable income subject to certain adjustments before allocation or apportionment.
  - The CIT tax base is apportioned by a sales factor, which is Michigan sales over sales everywhere. The sale of tangible personal property is sourced by destination. Receipts from services are sourced where the benefits are received.
  - The Small Business Alternative Credit is retained from the MBT. All other credits are eliminated for CIT purposes.
  - Taxpayers with a CIT liability of $100 or less need not file a CIT return or pay the tax.
  - A unitary business group is required to file a combined return.
  - Insurance companies are subject to a tax equal to **1.25%** of gross direct premiums written on property or risk located or residing in Michigan.

- Financial institutions are subject to a franchise tax equal to **0.29%** of the financial institution's net capital. Net capital means equity capital as computed in accordance with GAAP less the average daily book value of U.S. and Michigan obligations. Net capital is based on a 5-year average.

- ***Individual Income Tax***

  - Rate fixed at **4.25%**.
  - Public and private pensions, senior dividends and interest, and political contributions are no longer subtracted from AGI. Thus, these items will now be taxable.
  - The personal exemption allowance is fixed at the 2011 level of $3,700. Further, the exemption is phased out at a certain level of income. All special exemptions are repealed except for the exemption for disabled persons. Special provisions for military personnel and veterans are retained.
  - Changes to the property tax credit will reduce the 100% credit for seniors to 80%, increase the current 60% credit for other claimants to 80%, and retain the 100% credit for disabled persons. The property tax credit maximum of $1,200 is retained.
  - The phase-out range for the property tax credit is lowered to $61,000 to $70,000 from the current $73,650 to $82,650.
  - Many other credits are repealed going forward including:
    - Earned income tax credit
    - Energy efficient home improvement credit
    - Historic preservation credit
    - Film production wage withholding credit
    - City income tax[] credit
    - Gifts: public art, radio, colleges, universities, archives, museums, libraries credit
    - Community foundations, food banks and homeless shelters credit
    - College tuition and fees credit
    - Automobile donation credit
    - Family/Individual development accounts credit
    - Renewable energy surcharge credit
    - Medical care savings accounts credit

As illustrated below, the tax restructuring plan is essentially revenue neutral by fiscal year 2013.

Tax Restructuring Plan
(dollars in millions)

Revenue Adjustments:	FY 2012	FY 2013
Current Law:		
Michigan Business Tax (MBT)	$2,170.0	$2,024.4
Proposed Reforms:		
MBT (Repealed 12/31/11)	$900.2	$0.0
Corporation Income Tax (Effective 1/1/12)	$460.1	$748.8
Financial Institutions Tax	$27.7	$43.9
Certified Credits Already Awarded	($293.0)	($500.0)
Net Business Tax Revenue After Credits	$1,095.0	$292.7
Individual Income Tax Changes	$820.9	$1,863.8
Reserved for Future Tax Cuts	----	($100.0)
Net Impact: Proposed Tax Changes	$1,915.9	$2,056.5
Net Change from Current Law	($254.1)	$32.1

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Background

The MBT was enacted in July 2007 and became effective with the 2008 tax year. It primarily consists of a modified gross receipts tax and a business income tax levied on all business entities, including pass-through entities that are not subject to business-level taxation in most other states. The MBT also includes a 21.99% surcharge on tax liability, further increasing the tax burden on businesses.

In addition to the multiple complicated tax bases, the MBT contains over 30 credits. Michigan is projected to forego almost $2 billion in revenue for these special dispensations in fiscal year 2013. These excessive tax expenditures represent spending done through the tax code and not through the more transparent appropriations process.

The Income Tax Act calculates tax liability beginning with the adjusted gross income (AGI) from the federal income tax return. The tax is then determined by three types of adjustments. First, there are adjustments to the federal AGI to arrive at Michigan income. Second, various personal exemption allowances are subtracted from the Michigan income to arrive at taxable income. A tax rate is applied to the taxable income to arrive at the tax. Third, various credits are subtracted from the tax to determine the actual tax liability.