House Legislative Analysis Section
Olds Plaza Building, 10th Floor
Lansing, Michigan 48909
Phone: 517/373-6466

SBT: APPORTIONMENT/CAD/ETC.

House Bill 4358 as enrolled
Public Act 284 of 1995
Sponsor: Rep. Kirk A. Profit

House Bill 4404 as enrolled
Public Act 230 of 1995
Sponsor: Rep. Barbara Dobb

House Bill 4605 as enrolled
Public Act 283 of 1995
Sponsor: Rep. Charles Perricone

House Committee: Tax Policy
Senate Committee: Finance

Senate Bill 342 as enrolled
Public Act 282 of 1995
Sponsor: Sen. William Van Regenmorter

Senate Bill 472 as enrolled
Public Act 291 of 1995
Sponsor: Sen. Walter North

Senate Bill 545 as enrolled
Public Act 285 of 1995
Sponsor: Sen. Dale L. Shugars

Senate Committee: Finance
House Committee: Tax Policy

Second Analysis (3-7-96)

THE APPARENT PROBLEM:

Michigan's Single Business Tax (SBT) was enacted in 1975, replacing the corporate income tax and a half-a-dozen other taxes on business. It is unique; no other state has a tax like it. Tax specialists describe the SBT as a value-added tax, which means that a firm is taxed on the value it adds to the inputs it employs in producing whatever it is that it produces. Under the SBT, a business's tax base is the sum of compensation paid, profits, interest paid, and depreciation. (An alternative description, as used in a recent explanation of the tax by the Department of Treasury, is that the tax base is "the difference between the sales price of the product and the cost of materials used to make a product.") A company that does business in many states, whether headquartered in Michigan or elsewhere, arrives at its "apportioned tax base" by using a three-factor formula based on the percentage of its total payroll, the percentage of its total property, and the percentage of its total sales in Michigan. The three factors were given equal weight until the passage of Public Act 77 of 1991, and currently the sales factor is weighted 50 percent and the property and payroll factors are weighted 25 percent each. There are also various reductions that can be made in the tax base, the most important of which is the capital acquisition deduction (CAD). This allows a company to deduct from its tax base real and personal property investments, in Michigan and elsewhere, in the year made. Multistate firms apportion the CAD using the same formula referred to above. (With the CAD, the tax base has been described in a Department of Treasury report as "sales minus material and capital costs.")

There are a great many exemptions and deductions that affect who pays the SBT. According to a report on the SBT for the years 1988-89 issued in August of 1994 by the Department of Treasury, about 190,000 firms registered to pay the tax had no tax liability. Of the 94 firms that had an SBT liability, 85 percent paid only 11.2 percent of the total revenue. The SBT accounted for 15.4 percent of total state tax revenue in fiscal year 1993, with a revenue total of $1.98 billion, according to the treasury department.

Representatives of Michigan business interests have endorsed legislation that would alter the apportionment formula for multistate companies to put more emphasis on the sales factor and less (or no) emphasis on the property and payroll factors. This would, they say, reward (rather than penalize) companies for their investments in the state and for the jobs they provide here and would encourage businesses to locate their operations and headquarters in Michigan. Currently, they say, a Michigan business with the same amount of product sales in the state as an Ohio-based firm would have a larger SBT burden than the out-of-state firm. Other tax specialists have recommended, as part of any overhaul of the SBT, making the CAD available only for capital investments made in Michigan. Currently, capital investments anywhere can be deducted once the apportionment formula has been applied. This means multistate companies can get a CAD without investing in Michigan and also that multistate companies making substantial investments in the state get a CAD that does not reflect the full amount of the investment. Some people believe that a Michigan-specific CAD would provide a greater incentive for capital investments in the state.

Another feature of the SBT is the small business credit. This is available, up to 100 percent of tax liability, to companies whose gross receipts do not exceed $10 million and whose adjusted business income does not exceed $475,000. A further requirement is that no officer or owner in the firm can, generally speaking, receive more than $95,000 as compensation or as a share of business income. Firms that qualify can choose one of two methods of calculating their SBT liability: either by claiming a credit derived by dividing adjusted business income by 45 percent of the tax base; or by an alternative method that sets the tax liability at two percent of adjusted business income. Small business advocates note that the so-called compensation limiter of $95,000 presents a "cliff" problem. If compensation or business income exceeds the limit, no credit is available whatsoever. If it is under the limit, a full credit is available. Advocates recommend a higher limit and recommend a gradual reduction of the credit rather than a cliff.

In 1994, the legislature enacted amendments to the Income Tax Act aimed at putting private pension and retirement income on a more equal footing with income from public sector pensions. Prior to the amendments, public pensions were not taxed, but income from private pensions beyond $7,500 for single returns and $10,000 for joint returns was subject to the state income tax. The exemptions for private pensions were increased to $30,000 for a single return and $60,000 for a joint return. (Very few public pensions, it was said, exceed these limits.) At the same time, some people argued that senior taxpayers who had no pension income whatsoever but who had income from savings and investments or from the sale of businesses or farms should get similar consideration. For such senior citizens, the 1994 legislation provided an exemption for interest and dividend income up to $1,000 for single filings and $2,000 for joint filings. Proponents described this at the time as only a small step in the right direction. Legislation has now been proposed to improve treatment for non-pension retirement income.

THE CONTENT OF THE BILLS:

House Bills 4358 and 4605 and Senate Bills 342 and 545 would all amend the Single Business Tax Act (MCL 208.23 et al.). House Bill 4404 and Senate Bill 472 would amend the Income Tax Act (MCL 206.30 and 206.30c). A description of the bills follows.

<u>Tax Base Apportionment Formula.</u> <u>House Bill 4605</u> would establish a tax base apportionment formula for tax years 1997 and 1998 that weighs property 10 percent, payroll 10 percent, and sales 80 percent. <u>Senate Bill 342</u> would establish a formula for 1999 and thereafter that weighs property 5 percent, payroll 5 percent, and sales 90 percent. (The current weighting is 25-25-50.)

However, if the new provisions regarding the capital acquisitions deduction, or CAD, as described below, were not in effect (e.g., due to a court challenge), then the apportionment formula would be the current one of 25-25-50 until 1998, 20-20-60 in 1998, and 15-15-70 after 1998.

Site-Based ("Michigan-Only") Apportioned Capital Acquisitions Deduction. Under Senate Bill 342, the capital acquisitions deduction (CAD) for assets that are not mobile tangible assets would be allowed only for assets located in Michigan for use in a business activity in the state. The CAD would be subject to the same apportionment formula as applied to determining the tax base. (Currently, the apportioned CAD applies to assets no matter in which state the assets are located.) Also, firms could claim a deduction for tangible assets purchased or acquired for use outside of the state and later moved into the state for use in a business activity. In such cases, they could deduct the federal basis used for determining gain or loss as of the date the assets were physically located in Michigan plus the cost of fabrication and installation of the assets in the state. Similarly, such assets transferred out of the state would be added back to the tax base.

For mobile tangible assets, determination of the CAD would remain unchanged. The term "mobile tangible assets" would refer to motor vehicles with a gross vehicle weight rating of 10,000 pounds or more and used to transport persons for compensation or property, rolling stock, aircraft, and watercraft used by the owner to transport persons or property for compensation or used by the owner to transport the owner's property for sale, rental, or further processing, and equipment used directly in completion of or construction contracts for the planning, design, construction, alteration, repair, or improvement of property.

Exception for Certain Retailers. The provisions above would also not apply, and thus the current CAD provisions would remain in place, for an entity headquartered in Michigan and incorporated prior to the effective date of the bill that derives more than 50 percent of its total sales from the retail sale of fresh, frozen, or processed food, food products, or consumable necessities; household products; prescriptions; health and beauty care products; cosmetics; pet products; carbonated beverages; and beer, wine, or liquor. Also, the company's retail sales of prescriptions would have to be more than 2 percent and less than 10 percent of its total retail sales.

Additional Temporary Credit. Senate Bill 342 also would provide an additional credit for the 1997, 1998, and 1999 tax years. This credit would be calculated by, generally speaking, subtracting a company's tax liability using the CAD and apportionment formula that existed prior to this legislation from the tax liability under the new legislation, and then subtracting $5 million from that result. (This would limit the tax increase from the changes in the CAD and apportionment formula to $5 million annually for companies that could use this credit.)

(Senate Bill 342 contains a provision specifying that if any portion of the new CAD is declared unconstitutional in a decision rendered by an appellate court and if that decision is not under appeal, then none of the CAD provisions in the bill would be effective.)

Compensation Limit for Small Business Credit. House Bill 4358 would amend the Single Business Tax Act to raise the small business credit compensation limit from $95,000 to $115,000 and to allow a partial credit in cases where an officer or owner received compensation or a share of business income between $95,000 and $115,000. Under the bill, the credit would be reduced by 20 percent if compensation was more than $95,000 but less than $100,000; by 40 percent between $100,000 and $105,000; by 60 percent between $105,000 and $110,000; and by 80 percent between $110,000 and $115,000. Senate Bill 545 would specify how the reductions would be calculated for partnerships, subchapter-S corporations, and other corporations.

Income Tax Deduction for Senior Citizens. House Bill 4404 and Senate Bill 472 would amend the Income Tax Act (MCL 206.30 and 206.30c) to increase the deduction senior citizens can take for interest, dividends, and capital gains. House Bill 4404 would raise the deduction from $1,000 for a single return and $2,000 for a joint return to $3,500 and $7,000, respectively, for 1997. Senate Bill 472 would raise the deduction to $7,500 and $15,000 for the 1998 tax year and thereafter. The exemption would have to be reduced by the amount of any deductions for pension and retirement income. The term "senior citizen" refers to a person 65 years of age or older or an unremarried surviving spouse.

FISCAL IMPLICATIONS:

According to estimates by the Office of Revenue and Tax Analysis in the Department of Treasury, the package of bills would result in an overall revenue reduction of $9.5 million in 1997; $53.6 million in 1998; $128.4 million in 1999; and $153.6 million in 2000. Of that, the revenue loss attributable to the increased income tax deduction for senior citizens would be $17.6 million in 1997; $49.3 million in 1998; $60.5 million in 1999; and $63.2 million in 2000. Raising the small business credit compensation limit and allowing a phase-out of the credit would result in revenue reductions of $15.5 million in 1998; $21.6 million in 1999; and $22.6 million in 2000. The change in the tax base apportionment formula combined with the site-based apportioned CAD would result in revenue gains of $8.1 million in 1997 and $11.2 million in 1998 and revenue losses of $46.3 million and $67.8 million in 1999 and 2000. (The change in the apportionment formula produces revenue losses, the change in the capital acquisition deduction produces revenue increases. The apportionment formula losses are $178.7 million in 1997; $246.3 million in 1998; $300 million in 1999; and $327 million in 2000. The revenue gains from the new CAD would be $186.8 million in 1997; $257.5 million in 1998; $253.7 million in 1999; and $259.9 million in 2000.) (11-9-95)

ARGUMENTS:

For:

This package of bills represents affordable tax relief. It provides tax reductions for small business in the state, for senior citizens, and for Michigan-based multistate corporations that provide high-wage jobs in Michigan while selling their products all over the country and the world. While the package is not all that some business and manufacturing advocates wanted, it still will benefit the state's economy by keeping business and industry in the state and by encouraging additional investment here. Small businesses benefit from increasing the amount of compensation an officer or owner can receive and still qualify for the alternative tax computation for small businesses under the SBT. The current limit is too low at $95,000 and has a "cliff" problem. A company one dollar over the limit gets no tax benefit. The bill will allow for a phased-out credit up to a new limit of $115,000. While some would prefer a higher limit, this at least allows additional small businesses to qualify. The package also provides that only capital investments made in Michigan qualify for the capital acquisition deduction under the SBT. (It also requires the CAD to be apportioned, which reduces the impact of this proposal on state tax revenues.)

Shifting to a heavier emphasis on the sales factor in apportioning the SBT will create a level playing field between Michigan-based multistate companies and their out-of-state competitors and boost the state's economic development. As it is currently calculated, the SBT penalizes multistate companies for having property and payroll in Michigan. This proposal dramatically changes that. It removes the disincentive to adding plant and payrolls in the state; it encourages manufacturers (and others) engaged in deciding where to locate new operations to locate in Michigan. It helps prevent Michigan-based companies from leaving the state. The state's economy as a whole will benefit, not just the companies and employees directly affected. Advocates of a sales-based formula note that the current system results in inequities of many kinds. A company based in Michigan and selling mostly in Michigan is at a disadvantage currently compared to a company based in Ohio or Indiana with the same volume of sales in Michigan. The new formula will correct that; they will pay more nearly the same amount.

It should be noted that over 65 percent of Michigan businesses do not even pay the SBT, and that 15 percent of the companies that do pay the SBT contribute nearly 90 percent of the total revenue. Recent SBT cuts have had across-the-board benefits (e.g., lowering the rate, and eliminating unemployment insurance, workers compensation insurance, and Social Security from the tax base) or have mainly benefitted small businesses. The change in the apportionment formula provides tax relief to the Michigan-based companies carrying a large SBT burden. It makes those multistate companies who exploit the state's markets and compete with Michigan companies but who have little or no investment in Michigan pay more.

Against:

The change in the SBT tax base apportionment formula unfairly picks winners and losers within the business sector. It will produce a massive tax shift, with dramatically lower taxes for some kinds of businesses and large tax increases for others. Most of the benefit goes to a relatively small group of large manufacturers. Tax relief ought to be spread widely across business and industry in order to improve the business climate. The great majority of companies, whose operations and sales are entirely in Michigan, get nothing from the tax base changes in House Bill 4605 and Senate Bill 342. (This is, of course, because they are not subject to the apportionment formula.) Only multistate companies benefit. And the major benefit goes to multistate companies with considerable property and payroll in Michigan whose products are primarily sold outside the state. Moreover, the bills provide a significant tax increase for many multistate businesses operating in Michigan. Some of those that will suffer a tax increase are already among the largest SBT-paying companies. Large chain retailers will see a serious negative effect, say their representatives. National companies selling gasoline throughout Michigan also say they will see large tax increases. These companies are important to the state's economy and are key job providers.

Critics of the sales-based tax formula say that it means the SBT will be less stable than before, more susceptible to economic swings, and that companies will have more incentive to engage in manipulation of the point of sale to attempt to escape the tax. (Companies could sell through specially created intermediaries or sales agents, for example.) Also, to the extent the SBT burden is supposed to be related to government services provided to taxpayers, there will be a mismatch. For example, a major manufacturer, operating worldwide, with 40 percent of its plant and payroll in Michigan but only 5 percent of its sales here will see a tax cut, but there will be no reduction in the government services they receive. Further, this kind of tax policy, under which a state protects and favors its own businesses, will lead to retaliation by other states. Very few other states currently weight sales this heavily in their business tax systems. It should be noted that the examples of proponents showing an advantage for out-of-state firms relative to the SBT ignore the home state taxes such firms must pay.

There are better, fairer, ways to lower the business tax burden that do not punish a selected group of companies. The tax rate could be lowered, benefitting everyone. Health care costs could be removed from the tax base. Personal property taxes could be eliminated or greatly reduced.

For:

Last year the legislature put private pension income on an equal footing, for state income tax purposes, with public pension income. House Bill 4404 and Senate Bill 472 take the next step. They provide an exemption for some of the income a senior citizen receives from interest, dividends, and capital gains. (Income earned by senior citizens would still be subject to the income tax.) A great many people do not receive a pension (or receive minuscule pensions) but provide for their retirement through savings or through the sale of businesses built up over a lifetime. Why should people who have saved throughout their working lives be taxed on their retirement income when those fortunate enough to receive pensions (whether public or private) do not have to pay state income taxes?

Response:

It should be noted that House Bill 4404 and Senate Bill 472 do not apply, strictly speaking, to retirement income, as previous legislation regarding the tax status of pensions did. The tax exemption applies to dividends, interest, and capital gains of senior citizens no matter what their status, whether retired or working, and without regard to their level of earned income.

Against:

One of the bills, Senate Bill 342, contains a provision that gives special treatment to one kind of Michigan-based retailer; indeed, reportedly only one company, Meijer, would benefit from it. This is not good tax policy.

Against:

This additional permanent reduction in tax revenue could lead to serious budget problems in the future. When state revenues are no longer so robust, when the state economy sputters, how will the state meet its obligations? Over $225 million in cuts in the SBT have been made since 1991.

Response:

Some advocates of the change in the apportionment formula argue that there will be no loss of revenue from that. They say that projections of revenue loss do not reflect the possibility of the increased economic activity that should occur in the state as a result of the change. They say anticipated losses did not occur when the formula changed from 33-33-33 to 25-25-50.

Against:

The greater the emphasis on sales in the apportionment formula, the less the SBT looks like a true value-added tax. With all the recent changes to the SBT, perhaps it is time to re-examine its purposes and structure comprehensively.