Legislative Analysis

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SINGLE BUSINESS TAX REPLACEMENT

House Bill 4367 (Substitute H-4)
Sponsor: Rep. Barbara Farrah

Committee: Tax Policy
Complete to 5-9-07

A SUMMARY OF HOUSE BILL 4367 AS PASSED BY THE HOUSE 5-2-07

House Bill 4367 (H-4) would create a new act, known as the Michigan Business Tax Act (MBT), to replace the Single Business Tax, which is set to expire on December 31, 2007. Highlights of the substitute bill include:

- A tax of 6.95% on business income.
- A tax of 0.488% on net worth.
- An increase in the tax on insurance companies from the current effective rate of 1.07% to 1.25%, yet still retaining a number of industry-specific credits.
- Subjecting insurance companies to sales and use taxes.
- A credit for certain regulated firms (generally finance, insurance, and real estate).
- A credit equal to 0.8% of compensation.
- A 3.3% investment tax credit similar to the existing credit against the SBT.
- A credit equal to 4.0% of research and development expenses.
- A credit equal to half of contributions made to a partnering small business engaged in research and development, capped at $500,000.
- Retaining the current SBT filing threshold of $350,000 in gross receipts, but eliminating the "cliff effect" for businesses with gross receipts in excess of $350,000 by phasing in tax liability for businesses with gross receipts between $350,000 and $700,000.
- Retaining the alternative tax on small businesses currently provided for in the SBT, but reducing the rate from 2% to 1.8%.
- Retaining many of the current economic development credits, including those related to the Michigan Economic Growth Authority, brownfield redevelopment, and historic preservation.
- Retaining a number of miscellaneous credits from the SBT.
- A credit equal to 50% of personal property taxes for industrial and utility property.
- Requiring unitary filing for corporate groups.
- Apportionment based solely on the sales factor.
- Market-based, rather than cost-of-performance, sourcing of sales.
- A credit for capital expenditures at the Michigan International Speedway.

The other main feature of the tax plan is a 24-mill reduction in personal property taxes on commercial and industrial property. This includes the 6-mill State Education Tax and the

18 mills levied for local school operating purposes. The property tax reductions are found in House Bills 4369-4372.

Taxpayers (Section 7)

A taxpayer would be an individual, firm, bank, financial institution, limited partnership, limited liability partnership, co-partnership, partnership, joint venture, association, corporation, subchapter S corporation, limited liability company, receiver, estate, trust, any other group or combination of groups acting as a unit, or a unitary business group.

Business Income Tax (Section 20)

The MBT would impose a tax at a rate of 6.95% on business income, with certain adjustments and after allocation and apportionment, on every taxpayer with "business activity" within the state, unless prohibited by federal P.L. 86-272 (15 USC 381 to 384).[1] Business income generally means that part of federal taxable income that is derived from business activity.

Adjustments to business income, prior to apportionment and allocation, include (1) adding interest income and dividends derived from obligations or securities of other states, in the same amount excluded from federal taxable income, less related expenses not deducted in computing federal taxable income under Sections 265 and 291 of the federal Internal Revenue Code; (2) adding all taxes on income or measured by net income, to the extent deducted in calculating federal taxable income; (3) adding any carryback or carryover of a net operating loss, to the extent deducted in calculating federal taxable income; (4) deducting royalties and dividends received from persons other than U.S. persons; (5) adding the loss or subtracting the income attributable to another entity whose business activities are taxable under the bill or would be taxable were the entity located in Michigan; (6) add any interest, royalty, or other expense paid to a related person not included in a unitary business group for use of an intangible asset, to the extent deducted in calculating federal taxable income.

Adjustments to business income, after allocation and apportionment, would include deducting any available business loss, including a business loss carryforward calculated under Section 23b(h) of the SBT Act.

Net Worth Tax (Section 22)

Additionally, the bill would impose a tax at a rate of 0.488% on the net worth (after allocation and apportionment) on every taxpayer with business activity in the state. The

[1] Public Law 86-272, enacted in 1959, generally prohibits states from imposing a tax on the income of a corporation derived from interstate commerce if the only business activities within the state by or on behalf of the corporation are the solicitation of orders of tangible personal property where orders are sent outside of the state for acceptance or rejection and, if accepted, are filled by shipment or delivery from a point outside of the state. Additionally, PL 86-272 provides that independent contractors may engage in soliciting sales, making sales, and maintaining a sales office within a state without subjecting the corporation to taxation.

bill states that the tax "is not a tax on business income and is imposed to the fullest extent permitted by the U.S. constitution without regard to whether a taxpayer is subject to the business income tax…" Net worth would generally be a firm's total assets less total liabilities, computed in accordance with generally accepted accounting principles.

Unitary Business Groups

The bill (Section 65) requires unitary business groups to file a combined return that includes each U.S. person included in the group. The bill notes that each person shall be treated as a separate taxpayer and that all intercompany transactions would be excluded from the business income and net worth tax bases as well as the apportionment formula. Under the bill (Section 9), a unitary business group is a group of U.S. persons, one of which directly or indirectly owns more than 50% of the ownership interest (with voting rights) of the other persons, that has business activities or operations that result in the flow of value between persons included in the group or multiple persons, or in a flow of value within a single legal entity irrespective of whether each entity is a sole proprietorship, corporation, partnership, limited liability company, trust, or other person.

The business income tax base of a unitary business group would be the sum of the business income tax base of each person included in the group, less any items of income and related deductions from transactions between persons included in the group.

For unitary business groups, net worth is the difference in assets and liabilities of the group at the close of the business on the last business day of the tax year as shown by a pro forma consolidated balance sheet including all persons included in the group.

Exemptions (Section 24)

Generally, the bill would retain exemptions from the SBT Act (MCL 208.35) for the following: (1) the U.S. government, the state, other states, and political subdivisions; (2) charitable and educational institutions exempt from federal income taxes; (3) nonprofit cooperative housing associations; (4) the production of agricultural goods; (5) farmers' cooperatives; (6) activities under the Agricultural Commodities Marketing Act; (7) services provided by an attorney-in fact; and (8) multiple employer welfare arrangements providing dental benefits.

Insurance Companies (Chapter 2A)

Under current law, insurance companies are liable for the SBT or the so-called retaliatory tax (if applicable) levied under the Insurance Code, whichever is greater.[2] The SBT Act (MCL 208.22a) provides that the tax base and adjusted tax base of an insurance company is 25 percent of the company's adjusted receipts, subject to any apportionment. Adjusted

[2] Under the Insurance Code's retaliatory tax, MCL 500.576a, when an insurer's state of incorporation imposes a larger aggregate tax burden on a Michigan insurer doing business in that state than Michigan imposes on a company from that state doing business in Michigan, the foreign insurer must pay Michigan a tax equal to the difference in aggregate tax burdens.

receipts generally include, among other items, gross direct premiums, rental and royalty receipts, and receipts from business activity other than the business of insurance. In addition, insurance companies are subject to a "surcharge" under MCL 208.22b equal to 1.26 times the company's tax liability before application of certain credits. The total tax of an insurance company under the SBT calculates out to be 1.0735 percent of the company's adjusted receipts, less certain industry-specific credits and other credits.

The bill would impose a tax on insurance companies of 1.25 percent of gross direct premiums written on property or risk located or residing in the state, but not including premiums on policies not taken, returned premiums on cancelled policies, receipts from the sale of annuities, and receipts on reinsurance premiums if the tax has been paid on the original premiums. The bill would also exempt the first $190 million of disability insurance premiums written in the state, other than credit insurance and disability income insurance premiums. The exemption would be reduced by $2 for each $1 by which gross direct premiums from insurance carrier services within the state and outside of the state exceed $450 million.

The bill would <u>retain</u> industry-specific credits for amounts paid to the Michigan Worker's Compensation Placement Facility, Michigan Basic Property Insurance Association, Michigan Automobile Insurance Placement Facility, Property and Casualty Guaranty Association, and the Michigan Life and Health Guaranty Association. (See SBT Act MCL 208.22c) The bill would also retain a credit equal to half of the examination fees paid by the company during the tax year. (See MCL 208.22e). Additionally, the bill provides insurance companies with a credit equal to 0.8% of compensation paid in the state, up to half of a company’s tax liability after claiming the other credits.

The bills provides that the tax would be in lieu of all other privilege or franchise fees or taxes imposed by any other law, *except* taxes on real and personal property, sales and use taxes, and except as otherwise provided in the bill and in the Insurance Code. The SBT Act (MCL 208.22) provides that the SBT is imposed in lieu of all other privilege or franchise fees or taxes imposed by another law, except taxes on real and personal property. (Thus, the bill newly subjects insurance companies to sales and use taxes.) Also, as with current law, insurance companies would be subject to the MBT or the retaliatory tax imposed under the Insurance Code, whichever is greater.

Apportionment (Chapter 3)

The bill would apportion the business income and net worth tax based on the sales factor, which would be a fraction where the numerator is total sales in Michigan and the denominator is total sales everywhere. For unitary business groups, sales include sales of every person included in the group irrespective of whether a person has nexus in Michigan, although sales between persons included in the group would be excluded in determining the sales factor. The bill would retain a provision (MCL 208.54) permitting spun off corporations (Delphi and Visteon) to exclude from Michigan and total sales, for the purposes of calculating the sales factor, sales to its immediately preceding former parent corporation.

Sourcing

Generally, under the SBT Act, for the purpose of calculating the sales apportionment factor, the sales of services and intangible property (i.e. sales other than sales of tangible personal property) are "sourced" to Michigan if a greater proportion of business activity, based on the cost of performance, occurs within Michigan than outside of Michigan.[3] The bill, instead, uses a "market-based" method of sourcing sales to Michigan, in which sales are sourced based on where the location of the purchaser or where the good or service is used. (This is similar to the sourcing of sales of tangible personal property both under the SBT and the bill.) The bill includes specific sourcing provisions for the following:

- Receipts from the lease or rental of tangible personal property.
- Receipts from the lease or rental of mobile transportation property.
- Royalties and other income received for the use of, or privilege of using, intangible personal property.
- Sales derived from securities brokerage services.
- Receipts from the origination of a loan.
- Interest from loans.
- Receipts from credit card receivables.
- Loan servicing fees.
- Receipts from the sale of securities and other assets from investment and trading activities.
- Receipts from transportation services.
- Receipts from the sale of telecommunication services.

Regulated Activities Credit (Section 40)

The bill provides a credit to firms engaged in certain "regulated activities" (generally financial, insurance, and real estate firms) against the net worth tax equal to the following:

$$\begin{array}{c}\text{Net worth tax base}\\ \text{(allocated and apportioned)}\end{array} \times 0.17\% \ \frac{\text{Total sales in Michigan for regulated activities}}{\text{Total sales in Michigan}}$$

Under the bill, "regulated activities" would mean those business activities regulated under the Banking Code; Credit Union Act; Savings Bank Act; Savings and Loan Act; Mortgage Brokers, Lenders, and Servicers Licensing Act; Secondary Mortgage Loan Act; Consumer Financial Services Act; 1984 PA 379 (credit cards); Motor Vehicle Sales Finance Act; Regulatory Loan Act; Home Improvement Finance Act; Retail Installment Sales Act; Deferred Presentment Service Transactions Act; Uniform Securities Act; Money Transmission Services Act; Debt Management Act; Article 25 of the

[3] The "cost of performance" means those costs directly related to the activity performed for a client determined in a manner consistent with the taxpayer's method of accounting for federal income tax purposes. The cost of performance is determined separately for each sale.

Occupational Code (real estate); and Chapter 12 of the Insurance Code (agents, solicitors, adjustors, and counselors).

Compensation and Investment Tax Credit (Section 41)

The bill also provides a combined compensation and investment tax credit that must be taken after the regulated activities credit (Section 40) and before any other credit. The credit is limited to 75% of total tax liability. The credit is equal the sum of 0.8% of the taxpayer's compensation in Michigan and 3.3% of net capital assets.

In general, the investment credit is carried over from the Investment Tax Credit against the SBT (MCL 208.38a). Net capital assets generally includes the costs (including fabrication and installation) of tangible assets located in Michigan; apportioned mobile tangible assets, wherever located; and the federal basis for eligible items moved into the state; less a recapture calculation for like assets upon their sale, disposition, or removal from the state. The assets must be of a type that are, or will become, eligible for depreciation, amortization, or accelerated capital cost recovery for federal income tax purposes.

In addressing a concern raised in committee, the bill specifies that compensation for taxpayers licensed under Articles 25 and 26 of the Occupational Code (real estate brokers, salespersons, and appraisers) includes payments made to independent contractor licensed under the two articles. A compensation credit is made available to insurance companies under Chapter 2A.

Research and Development Credits (Sections 42 and 43)

The bill also provides two research and development credits. One credit (Section 42) is equal to 4% of a taxpayer's research and development expenses, as defined in the federal Internal Revenue Code. (The SBT currently includes an R&D credit based on compensation, MCL 208.32).

The other credit is generally equal to half of the amount of an "eligible contribution" (the transfer of pecuniary interest in the form of cash for the purpose of research and development and technology innovation) in a business engaged in research and development that, together with any affiliates, employs fewer than 50 employees or has gross receipts of less than $10 million and no prior financial interest with the taxpayer claiming the credit. The credit would be capped at $500,000 per taxpayer. The Michigan Economic Growth Authority would approve the credit, and could not grant more than 25 credits in any one year. (This is identical to the R&D credit previously included as part of the governor's proposed Michigan Business Tax.)

Michigan International Speedway Credit (Section 43a)

The bill creates a credit for the 2008-2017 tax years for capital expenditures made at the Michigan International Speedway. The credit would not be refundable, and unused credits could not be carried forward to offset tax liability in future years. The amount of the credit would be capped at an amount still to be agreed to. (The bill caps the credit at $1, apparently using that figure as a placeholder until a final number is agreed to.)

Filing Threshold/Phased-In Liability (Sections 44 and 62)

Currently under the SBT Act (MCL 208.39a), businesses with gross receipts of $350,000 or less are not required to file an SBT return. The bill retains the current filing threshold. The bill also phases in the tax for firms with gross receipts between $350,000 and $700,000, by providing a credit against the tax equal to the firm's tax liability after the small business credit and before application of all other credits multiplied by a fraction, where the numerator is the difference between $700,000 and the firm's gross receipts and the denominator is $350,000.

Personal Property Tax Credit (Section 45)

In addition to the 24-mill reduction in personal property taxes provided for in the accompanying legislation, the bill also provides for a refundable credit equal to half of the taxes paid on industrial personal property and utility property subject to taxation under 1905 PA 282.

Small Businesses (Section 47)

The bill would retain the alternate rate calculation for small businesses currently provided for in the SBT Act (MCL 208.36), which permits firms to calculate their tax liability as 2% of adjusted business income. The bill would lower the rate to 1.8%. Firms eligible to use the alternate rate must meet the following criteria: (1) have gross receipts not exceeding $10 million; (2) have adjusted business income not exceeding $475,000; and (3) have individual or officer-allocated income not exceeding $115,000.

Retained Credits

The bill retains the following credits currently provided for in the SBT Act (with the appropriate section of the bill and the SBT Act in parentheses):

- Start-up businesses (Section 46/SBT MCL 208.31).
- Venture capital investment (Section 48/SBT MCL 208.37e).
- Charitable contributions (Section 49/SBT MCL 208.38).
- Worker's Compensation (Section 50/SBT MCL 208.38b).
- Community foundations (Section 51/SBT MCL 208.38c).
- Homeless shelters (Section 52/SBT MCL 208.38f).
- Alternate energy (Section 53/SBT MCL 208.39e).
- Michigan Economic Growth Authority (Section 54/SBT MCL 208.37c and 208.37d).
- Renaissance Zones (Section 55/SBT MCL 208.39b).
- Historic Preservation (Section 56/SBT MCL 208.39c).

- Brownfield development (Section 57/SBT MCL 208.38g).
- Low-grade hematite (Section 58, SBT MCL 208.39d).

Revenue Limit/Additional Credit (Section 59)

The bill provides that for tax years 2008 and 2009, if the total revenue collected from the tax in a tax year, excluding the tax liability of insurance companies, exceeds $2,501,000,000 in 2008 and $2,573,000,000 in 2009 by more than 10% after application of all credits under the act, the excess amount would be applied as a credit in the immediately following tax year, on a pro rated basis for taxpayers that claimed the compensation and investment tax credit (Section 41) or the compensation-based research and development credit (Section 42). The credit would not be refunded, but could be carried forward to offset future tax liability, for up to 10 years.

Miscellaneous Provisions

Chapter 6 of the bill generally includes a number of provisions from Chapter 4 of the SBT Act, which concerns the following (with the appropriate section of the bill and the SBT Act in parentheses):

- Estimated returns (Section 60/SBT MCL 208.71).
- First year computations (Section 61/SBT MCL 208.72).
- Annual returns (Section 62/SBT MCL 208.73).
- Furnishing copies of federal returns (Section 63/SBT MCL 208.75).
- Information returns (Section 64/SBT MCL 208.76).
- Administration and rules (Section 66/SBT MCL 208.80).

Revenue Distribution (Section 67)

The bill provides that revenue from the tax would be distributed as follows:

- FY 2007-2008: $203.7 million to the School Aid Fund and the balance to the General Fund.

- FY 2008-2009: $613.7 million to the School Aid Fund and the balance to the General Fund.

- Each subsequent fiscal year: The amount deposited to the School Aid Fund in the previous fiscal year, adjusted for inflation, shall be deposited to the School Aid Fund, and the balance to the General Fund.

Appropriation (Section 68)

The bill would appropriate $10 million to the Department of Treasury in FY 2006-2007 to carry out the requirements of the act. Any remaining unexpended balance at the close of the fiscal year would be carried forward in a work project account in accordance with the provisions of the Management and Budget Act.

Severability (Section 69)

The bill provides that if a court of competent jurisdiction determines that any of the provisions of the bill providing a deduction, credit, or exemption with respect to employment, persons, services, investments, or other activity in the state is unconstitutional or applies to a similar activity outside of the state, that provision would be severed from the bill and the remaining provisions would remain in effect.

Enacting Sections

The bill states that it is effective January 1, 2008 and applies to tax years beginning after December 31, 2007. The bill is tie-barred to HB 4369 (exempting commercial and industrial personal property from the local 18 school operating mills); HB 4370 (exempting commercial and industrial personal property from the 6-mill State Education Tax); HB 4371 (relating to the treatment of commercial and industrial property under the Industrial Facilities Tax); and HB 4372 (specifying in the General Property Tax commercial and industrial property is exempt from the 24 school mills).

FISCAL IMPACT:

The bill is intended to be revenue neutral relative to the Single Business Tax (SBT), which it is designed to replace. Although the bill would raise more revenue than the SBT, the additional revenue is used to offset the elimination of 24-mills of the personal property tax, the personal property tax credit, and the additional credits that were not available under the SBT. Additional information will be provided as it becomes available.

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