Legislative Analysis

INCOME TAX CHANGES

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House Bill 5420 as reported from committee as H-4
Sponsor: Rep. Roger Hauck

House Bill 5421 reported w/o amendment
Sponsor: Rep. Jeffrey R. Noble

House Bill 5422 as reported as H-1
Sponsor: Rep. Jim Tedder

Committee: Tax Policy
Complete to 1-25-18

BRIEF SUMMARY:

House Bill 5420 would amend the Income Tax Act to:

- Change definitions and references to reflect the recently enacted federal Tax Cut and Jobs Act of 2017, and remove references to personal and dependency exemptions allowed on a taxpayer's federal income tax return.
- Allow a taxpayer to claim personal and dependency exemptions on the state income tax, and set the amount of the exemption in statute at $4,300 for the 2018 tax year, $4,600 for the 2019 tax year, and $4,800 for the 2020 tax year and each tax year thereafter.

[An exemption reduces the amount of income subject to tax.]

House Bill 5421 would amend the City Income Tax Act to strike references to the federal Internal Revenue Code and replace them with references to the Income Tax Act, with regard to deductions for the personal and dependency exemptions on city income taxes.

House Bill 5422 would amend the Income Tax Act to allow a "qualified taxpayer" (an individual who is at least 62 years old at the close of the tax year) to claim a $100 credit against the income tax for a single or joint return, or a $200 credit for a joint return in which both spouses are qualified taxpayers.

[A credit directly reduces tax liability.]

The bills are tie-barred, meaning that none could take effect unless all three were enacted into law.

THE APPARENT PROBLEM:

Many experts, though not all, believe that recently enacted changes to the federal tax code—the Tax Cut and Jobs Act of 2017—have effectively eliminated Michigan's personal exemption. The federal income tax reform has reduced the personal exemption amount to $0 for a specific time period, and instead increased the standard deduction. Michigan's personal exemption is linked to the federal personal exemption: the amount of exemptions allowed for the state income tax includes a specific reference to the amount allowable on the federal income tax return.[1] Assuming that the number of exemptions will no longer be reported on the federal income tax return form (since its value is $0), there will be no ability for Michigan residents to claim personal exemptions; essentially, the exemption reference on the Michigan income tax return will refer to a number that no longer exists. Absent a state-level change and adhering to this interpretation, it is estimated that state income tax revenues would increase by about $1.5 billion during the first full year of implementation.

Additionally, according to many fiscal experts and state officials, the Michigan economy has experienced one of the longest economic expansions in its history. The unemployment rate is at historic lows, the population has stabilized, the economy has diversified from its traditional manufacturing base, and the state's main budget funds show baseline revenue growth. Many believe that recent policies have contributed to the strength of the state's economy, its improved business and job creation climate, and its low levels of unemployment, while continuing to generate the tax revenues needed to meet the state's responsibilities. In light of today's robust economy and the federal tax cuts, many also believe that Michigan taxpayers deserve some form of tax relief at the state level.

In response to the federal tax changes, the Governor introduced a proposal to restore and increase the personal exemption for Michigan taxpayers to account for the effects of other federal tax changes analyzed by the administration. The Senate and House have introduced different proposals. The House proposal would restore the personal exemption in Michigan and allow taxpayers to claim exemptions, and would provide tax relief through additional increases in the personal exemption and the introduction of a new income tax credit for seniors.

THE CONTENT OF THE BILLS:

House Bill 5420

Currently under the Income Tax Act, a taxpayer can claim a personal exemption and multiply the amount by the number of personal or dependency exemptions "allowable on the taxpayer's federal income tax return pursuant to the internal revenue code." The bill would remove the reference to the federal income tax return and provide for the determination of exemptions as follows:

- Each taxpayer may claim 1 personal exemption. If a joint return is not made by the taxpayer and his or her spouse, the taxpayer may claim a personal exemption for the spouse if the spouse does not have any gross income and is not the dependent of another taxpayer.
- A taxpayer may claim a dependency exemption for each individual who is a dependent of the taxpayer for the tax year.

Currently under the act, the personal exemption amount is set at either an inflation-adjusted amount (rounded to the nearest $100) or an amount specifically set in statute, whichever is greater. The personal exemption amount for tax year 2017 is $4,000.

[1] See 2017 MICHIGAN Individual Income Tax Return MI-1040 line 9a. http://www.michigan.gov/documents/taxes/MI-1040_608962_7.pdf

The bill would set the following amounts in statute for the personal exemption:

- On and after January 1, 2014 and before January 1, 2018: $4,000.
- For the 2018 tax year: $4,300.
- For the 2019 tax year: $4,600.
- For the 2020 tax year and each tax year after 2020: $4,800.

The bill would repeal section 30e of the Income Tax Act. This section defines "dependent" as an individual for whom the taxpayer may claim a dependency exemption on the taxpayer's federal income tax return pursuant to the Internal Revenue Code.

The bill would add "dependent" to the definitions section of the act, and define it as "a dependent as defined in section 152 of the internal revenue code."

The bill would change the definition of "internal revenue code" and define it as the United States internal revenue code of 1986 in effect on January 1, 2018.

The bill would also repeal section 30f of the Income Tax Act, which provides for adjustments from taxable income for interest earned on the contributions to a taxpayer's education savings account and distributions that are qualified withdrawals from an education savings account, to the extent *not deducted* in determining adjusted gross income. Instead, the bill would allow a taxpayer to deduct, to the extent *included* in adjusted gross income, interest earned and qualified withdrawals.

The bill would make an identical change regarding interest and deductions for an ABLE savings account, allowing interest earned and qualified withdrawals to be deducted to the extent *included* in adjusted gross income.

Finally, the bill would require an additional deposit into the state School Aid Fund (SAF). An amount equal to all the revenue lost under the individual income tax as a result of the bill's changes regarding personal and dependency exemptions, as determined by the Department of Treasury, would be required to be deposited into the SAF.

MCL 206.8 et seq.

<u>House Bill 5421</u>
Currently under the City Income Tax Act, when computing taxable income, a taxpayer is allowed deductions for the personal dependency exemptions authorized by "the federal internal revenue code." The bill would remove this language, and instead refer to personal and dependency exemptions authorized by "Part 1 of the Income Tax Act of 1967" (i.e., the changes proposed in <u>HB 5420</u>).

MCL 141.631 and 141.644

<u>House Bill 5422</u>
The bill would add a new section to the Income Tax Act. For the 2018 tax year and each tax year thereafter, a "qualified taxpayer" could claim a $100 credit against the income tax (single or joint return), or a $200 credit for a joint return if each spouse were a "qualified taxpayer." If

the credit allowed exceeded the tax liability of the taxpayer, the amount that exceeded the tax liability would be refunded.

The bill would define "qualified taxpayer" to mean an individual who is 62 years of age or older at the close of the tax year.

Proposed MCL 206.254

FISCAL INFORMATION:

House Bill 5420

Under current law, the personal exemption is projected to increase due to inflationary adjustments from $4,000 in TY 2018 to $4,100 for TY 2019, $4,200 for TY 2020, and $4,300 for TY 2021. In contrast House Bill 5420 would increase the personal exemption to $4,300 in TY 2018, $4,600 in TY 2019, and $4,800 in TY 2020 and subsequent years until the inflation-adjusted amount under current law exceeds $4,800 at some point in the future. The table below presents the estimated personal exemption under current law, the proposed personal exemption under House Bill 5420, and the estimated annual revenue impacts.

Tax Year	Current Law Personal Exemption	Proposed Personal Exemption	Fiscal Year	Annual Impact (millions)
2018	$4,000	$4,300	FY 2017-18	($45.0)
2019	$4,100	$4,600	FY 2018-19	($157.5)
2020	$4,200	$4,800	FY 2019-20	($172.5)
2021	$4,300	$4,800	FY 2020-21	($157.5)

Because the bill holds the SAF harmless, the entire revenue impact would be borne by the general fund.

House Bill 5421

As written, House Bill 5421 would simply make technical amendments to the City Income Tax Act to change the definition of personal and dependency exemptions. Under current law, personal and dependent exemptions are defined by referencing the federal internal revenue code. However, to prevent any unintended consequences the federal Tax Cut and Jobs Act of 2017 might have toward eliminating the personal exemption in the City Income Tax Act, the definition is changed to reference the state Income Tax Act of 1967. Because the bill would be maintaining the existing personal and dependent exemptions, it would have no fiscal impact.

House Bill 5422

Relative to current law, House Bill 5422 would reduce net income tax revenue by approximately $200.0 million on an annual basis. According to 2016 population estimates, there were just under 2.0 million individuals aged 62 and over in Michigan, so if each senior filed for a credit, the net cost would approach $200.0 million. Because the credit would increase refunds (or reduce payments), the bulk of the revenue loss would be borne by the general fund.

ARGUMENTS:

For:

Proponents of the bill package generally make the following arguments:

- First and foremost, the changes reflected in House Bills 5420 and 5421 are a proactive step to provide certainty and consistency for all Michigan taxpayers. The tax changes at the federal level are complex, and Michigan must provide certainty for its residents and families that personal exemptions will be maintained for purposes of state and city income taxes. The state and cities should not receive a windfall in income tax revenue, and families should not be forced to pay more, simply because of a federal change. Regardless of the exact interpretation of the federal changes, Michigan policymakers are tasked with creating certainty for residents. The bills do just that.

- The income tax changes embodied in HBs 5420 and 5422 are a modest change that represent a commitment to tax relief, a statement of priorities that a portion of future tax revenue will be returned to the taxpayer for families—not state government—to spend as they choose. HB 5422 specifically provides a modest tax benefit for seniors, many of whom have worked for decades, contributed to communities, and raised children and grandchildren. They deserve tax relief. The changes are simply a response to the healthy tax revenues that are being produced by today's robust economy. In times of prosperity, with growing revenues and lapsed funds, it makes sense to return surplus revenue to the taxpayers who earned it and let them decide how to use it.

- Increasing the personal exemption, as proposed in HB 5420, is one of the most progressive ways to provide tax relief. A personal exemption sets a specific amount of money that is protected from taxation, with exemptions provided for individuals, nonworking spouses, and dependents. Utilizing the personal exemption as a means to provide tax relief is more beneficial to moderate and lower income taxpayers. This proposal, which increases the personal exemption above what it might otherwise be, should have widespread support since it protects more of an individual's hard earned income from taxation.

Against:

Opponents of the bill package generally make the following arguments:

- House Bills 5420 and 5422 go above and beyond what is required to simply make the federal tax changes revenue neutral to the state of Michigan and Michigan families. The best response would be for Michigan to enact proactive policies that will protect Michigan taxpayers from unexpected tax increases, while also maintaining stable revenue for the state to meet its important obligations. These bills go one step further—providing a tax cut that has not been properly planned or accounted for in the state budget. An unplanned tax cut will eventually lead to spending cuts or service reductions, offsetting any nominal tax gain to Michigan families and residents.

- Michigan has multiple spending priorities coming due in the short term as a result of previously enacted legislation. In essence, the state has already spent its future growth; it has no more to spend. These policies include the increasing earmark of use tax revenue to reimburse local units for revenue lost from personal property tax changes, the increasing earmark of individual income tax revenue for transportation purposes, and an expansion of the homestead property tax credit. These are important policies that were negotiated and enacted in a fiscally responsible way; the state simply cannot afford another big-ticket spending item. Michigan's economy has improved because the state has committed to a fiscal discipline that sets policies and priorities while accounting for long-term revenue, spending, and budget trends. House Bills 5420 and 5422 represent an erosion of this track record of success.

POSITIONS:

Representatives of the following entities indicated <u>support</u> for the bills:

National Federation of Independent Business (1-17-18; HBs 5420 and 5421)
Michigan Chamber of Commerce (1-17-18, 1-24-18)
Michigan Freedom Fund (1-24-18)
Americans for Prosperity (1-24-18; HBs 5420 and 5421)
State Employee Retirees Association (1-24-18; HB 5422)
Retired Detroit Police and Fire Fighters Association (1-24-18)

Representatives of the Department of Treasury indicated <u>no position</u> on the bills. (1-17-18)

Representatives of the Michigan League for Public Policy testified in <u>opposition</u> to HBs 5420 and 5422. (1-17-18)

Legislative Analyst: Patrick Morris
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■ This analysis was prepared by nonpartisan House Fiscal Agency staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.