



**Senate Fiscal Agency**  
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**BILL ANALYSIS**



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House Bill 5420 (Substitute H-4 as reported without amendment)  
House Bill 5421 (as reported without amendment)  
House Bill 5422 (Substitute H-1 as reported without amendment)  
Sponsor: Representative Roger Hauck (H.B. 5420)  
Representative Jeffrey R. Noble (H.B. 5421)  
Representative Jim Tedder (H.B. 5422)  
House Committee: Tax Policy  
Senate Committee: Finance

Date Completed: 2-12-18

### **RATIONALE**

The Federal Tax Cut and Jobs Act, which took effect on December 22, 2017, amended the Internal Revenue Code to revise tax rates and credits for United States taxpayers. One of the revisions reduces the personal exemption rate to \$0. It is widely believed that this change will negate the ability of Michigan taxpayers to claim personal exemptions on State and city income tax returns. Michigan's Income Tax Act and City Income Tax Act allow a taxpayer to claim a personal exemption based on a calculation that depends on the number of exemptions or dependency exemptions allowable on the taxpayer's Federal income tax return. Because taxpayers will not be claiming a Federal personal exemption, which has zero value, many believe that taxpayers therefore will be unable to claim Michigan's personal exemption, effectively increasing the amount of taxes they owe.

In addition, some believe that Michigan taxpayers should be given tax relief, since the State has experienced economic growth over the last few years.

In order to remove uncertainty surrounding Michigan's personal exemption and reduce individuals' tax liability, it has been suggested that amendments should be enacted to increase as well as preserve the State's personal exemption, and provide a tax credit for seniors.

### **CONTENT**

**House Bill 5420 (H-4) would amend Part 1 of the Income Tax Act to do the following:**

- Specify the number of personal and dependency exemptions a taxpayer would be allowed, and delete language under which the number of exemptions depends on the number allowed on a taxpayer's Federal return.
- Increase the personal exemption from the current \$4,000 to \$4,300 for the 2018 tax year, \$4,600 for the 2019 tax year, and \$4,800 for the 2020 tax year and each subsequent tax year.
- Require an amount equal to all revenue the State School Aid Fund lost as a result of the bill's changes regarding personal and dependency exemptions to be deposited in the Fund.
- Revise the deduction for contributions to and distributions from an ABLE savings account, and interest earned on contributions to education savings accounts.

**House Bill 5421 would amend the City Income Tax Act to do the following:**

- **Allow a taxpayer deductions for the full personal and dependency exemptions authorized by Part 1 of the Income Tax Act, instead of under the Internal Revenue Code, or a deduction of a minimum of \$600 for each personal and dependency exemption under the rules for determining exemptions and dependents under Part 1, instead of under the Internal Revenue Code.**
- **Allow a city to provide an exemption of a certain amount for a person with respect to whom a deduction under Part 1 of the Income Tax Act, instead of the Internal Revenue Code, would be allowable to another taxpayer and was therefore not considered to have a personal exemption.**

**House Bill 5422 (H-1) would amend the Income Tax Act to allow an individual who was 62 years of age or older at the close of the tax year to claim a \$100 credit for a single or joint return, or a \$200 credit for a joint return if each spouse filing the return were 62 or older, for the 2018 tax year and each subsequent tax year.**

All of the bills are tie-barred.

### **House Bill 5420 (H-4)**

#### **Personal Exemption**

Part 1 of the Income Tax Act imposes a tax at the rate of 4.25% on the taxable income of individuals. "Taxable income" means adjusted gross income as defined in the Internal Revenue Code (IRC), subject to a number of additions and deductions. In addition to these adjustments, the Act provides for a personal exemption multiplied by the number of personal or dependency exemptions allowable on the taxpayer's Federal income tax return under the IRC, to be subtracted in the calculation that determines taxable income.

The bill would delete reference to the number of exemptions allowable on a Federal tax return. Instead, the number of personal and dependency exemptions allowed would be determined as follows:

- Each taxpayer could claim one personal exemption; however, if the taxpayer and his or her spouse did not make a joint return, the taxpayer could claim a personal exemption for the spouse if the spouse, for the calendar year in which the taxpayer's taxable year began, did not have any gross income and were not the dependent of another taxpayer.
- A taxpayer could claim a dependency exemption for each individual who was a dependent of the taxpayer for the tax year.

The bill would repeal Section 30e of the Act, which defines "dependent" as an individual for whom the taxpayer may claim a dependent exemption on the taxpayer's Federal income tax return under the IRC. Under the bill, "dependent" would mean a dependent as defined in Section 152 of the IRC. (Under Section 152, "dependent" means a "qualifying child" or a "qualifying relative", as those terms are defined in that section.)

Currently, an individual with respect to whom a deduction under the IRC is allowable to another Federal taxpayer during the tax year is not considered to have an allowable Federal exemption for purposes of the Act's personal exemption, but may subtract \$1,500 in the calculation that determines taxable income. Under the bill, instead, an individual for whom a deduction under the Act's personal exemption was allowable to another taxpayer during the tax year would not be entitled to a personal exemption but could subtract \$1,500.

#### **Exemption Amount**

Section 30 of the Act sets the amount of the personal exemption at \$3,700, and requires the amount to be adjusted by an increase of \$100 when changes in the consumer price index trigger an increase, according to a formula in the Act. Section 30a of the Act specifies that the amount of

the exemption is \$4,000, or the inflation-adjusted amount required by Section 30, whichever is greater.

Based on these provisions, the amount of the personal exemption currently is \$4,000. The bill would amend Section 30a to increase the amount as follows:

- For the 2018 tax year, \$4,300.
- For the 2019 tax year, \$4,600.
- For the 2020 tax year and each subsequent tax year, \$4,800.

#### School Aid Fund Deposit

The Act requires the percentage of the gross collections before refunds from the income tax levied under Part 1 that is equal to 1.012%, to be divided by the income tax rate of 4.25% and deposited in the State School Aid Fund. In addition to this amount, the bill would require an amount equal to all revenue lost to the State School Aid Fund as a result of the changes implemented for personal and dependency exemptions in Sections 30 and 30a by the bill, as determined by the Department of Treasury, to be deposited in the Fund.

#### Exempt Dependent

Under the Act, an individual with respect to whom a deduction under the IRC is allowable to another Federal taxpayer during the tax year is not considered to have an allowable Federal exemption for purposes of the Act's personal exemption calculation, and is exempt from the income tax and not required to file a return, if the person has an adjusted gross income of \$1,500 or less. Under the bill, this would apply to a person with respect to whom a deduction was allowable to another taxpayer.

#### Deductions

Currently, to the extent *not deducted* in determining adjusted gross income, a taxpayer may deduct interest earned on contributions to the taxpayer's ABLE savings account, as well as distributions that are qualified withdrawals from an ABLE savings account to the designated beneficiary of the account. Under the bill, a taxpayer could deduct the interest and distributions to the extent *included* in adjusted gross income.

The bill also would repeal Section 30f of the Act, which allows a taxpayer to deduct interest earned on contributions to the taxpayer's education savings accounts to the extent not deducted in determining adjusted gross income, and to deduct distributions that are qualified withdrawals to the extent included in adjusted gross income. Under the bill, a taxpayer could deduct both the interest and the distributions to the extent included in adjusted gross income.

### **House Bill 5421**

The City Income Tax Act permits a city, by ordinance, to impose and collect a tax on the income of residents and on the earnings of nonresidents related to work or business activities conducted in the city. An individual taxpayer in computing his or her taxable income is allowed deductions for the full personal and dependency exemptions authorized by the Internal Revenue Code, or a deduction of a minimum of \$600 for each personal and dependency exemption under the rules for determining exemptions and dependents under the Code.

The bill, instead, specifies that an individual taxpayer would be allowed deductions for the full personal and dependency exemptions authorized by Part 1 of the Income Tax Act, or a deduction of a minimum of \$600 for each personal and dependency exemption under the rules for determining exemptions and dependents under Part 1 of the Act.

Under the City Income Tax Act, a city may provide for either an exemption from the tax levied under the Act if a person's adjusted gross income for the tax year is less than an amount specified by the ordinance, or an exemption in an amount to be specified by the ordinance, for a person with respect to whom a deduction under the Internal Revenue Code is allowable to another Federal taxpayer during the tax year and is therefore not considered to have a Federal personal exemption under the provisions above.

Instead, the bill would allow an exemption from the city income tax for a person with respect to whom a deduction under Part 1 of the Income Tax Act would be allowable to another taxpayer during the tax year.

### **House Bill 5422 (H-1)**

Under the bill, for the 2018 tax year and each subsequent tax year, a qualified taxpayer could claim a \$100 credit against Part 1 of the Income Tax Act for a single return and, except as otherwise provided, for a joint return. If each spouse filing a joint return were a qualified taxpayer, then that taxpayer could claim a \$200 credit.

If the proposed credit exceeded the taxpayer's tax liability for the tax year, the excess portion would have to be refunded.

"Qualified taxpayer" would mean an individual who is 62 years of age or older at the close of the tax year.

MCL 206.8 et al. (H.B. 5420)  
141.631 & 141.644 (H.B. 5421)  
Proposed MCL 206.254 (H.B. 5422)

### **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

#### **Supporting Argument**

With the Tax Cut and Jobs Act reducing the Federal personal exemption to \$0, there is widespread concern that Michigan taxpayers also will have their personal exemptions reduced to \$0 for State and city tax returns. Although some have argued that, under a different interpretation, Federal law does not prevent a Michigan taxpayer from claiming his or her personal exemption, it is important that the State have an unambiguous tax structure. House Bills 5420 (H-4) and 5421 would address this situation by explicitly retaining the personal exemption for State and city income taxes, without reference to the Federal exemption. The proposed solution is simple and would provide certainty for taxpayers.

#### **Supporting Argument**

The Tax Cut and Jobs Act's reduction, and effective elimination, of the Federal personal exemption, and, consequently, Michigan's personal exemption, will result in a tax increase for all Michigan residents who pay the income tax. If no action is taken by the State, the Department of Treasury estimates that the removal of personal exemptions will cost a family of four \$680. According to Senate Finance Committee testimony, the Federal changes will result in a tax increase of almost \$1.5 billion.

A tax increase of this magnitude is regressive, and will create an unacceptable financial burden on Michigan taxpayers. House Bills 5420 (H-4) and 5421 would prevent the inadvertent tax increase for Michigan taxpayers by ensuring that they could continue to receive personal exemptions.

### **Supporting Argument**

Michigan has seen great economic improvements during the difficult circumstances present over the last decade. According to the Governor's office, 540,000 private-sector jobs have been created since December 2010; 122,800 manufacturing jobs have been created since 2010, the most in the United States; Michigan's income growth rate since 2010 is the sixth highest in the nation; and the State has seen six consecutive years of population growth and eight years of unemployment reduction. The State's January 2018 Consensus Revenue Agreement estimates that wage and salary employment will continue to increase over the next three years, and that the unemployment rate will either remain consistent or decrease during that time. The report also projects combined General Fund and School Aid Fund revenue to increase through 2020.

Even though the Michigan economy has improved considerably over the last decade, Michigan taxpayers have not experienced significant tax relief in many years. House Bills 5420 (H-4) and 5421 would reduce the burden on individual taxpayers, build on the positive economic momentum the State has generated, and encourage further taxpayer spending and economic development.

### **Supporting Argument**

Many older Michigan residents have contributed to Michigan and its communities for decades while seeing little tax relief. In fact, as a result of legislation enacted in 2011, seniors now must pay tax on pension income. In the spirit of providing financial relief, as House Bills 5420 (H-4) and 5421 would do, House Bill 5422 (H-1) would give a tax credit to those who are 62 and older.

### **Opposing Argument**

While it is important to clarify Michigan's tax structure following the Federal tax modifications, and restore the personal exemption, increasing the exemption and creating a tax credit for seniors would be fiscally irresponsible because of budgetary constraints and financial uncertainty.

According to the State Consensus Revenue Agreement, the General Fund's balance has remained relatively level while the State's needs continue to grow. Current General Fund obligations will be strained in the future by increasing infrastructure deterioration, desires for health care and school funding expansion, financial draw from the phase-out of the personal property tax, and other unforeseen investments or expenses. For example, if Federal lawmakers reduced a program that many Michigan residents relied on, such as food assistance, the State could be required to cover more of the cost.

The combined fiscal impacts of House Bills 5420 (H-4), 5421, and 5422 (H-1) would significantly reduce the amount of taxes paid to the State by taxpayers, affecting the ability of the State to provide essential services or respond to unanticipated expenses or financial opportunities. There is no guarantee that economic benefits associated with the proposed tax relief would offset the loss of tax revenue.

With many unknowns in the State's budget and future, along with the expected financial challenge of addressing Michigan's deteriorating infrastructure, it would not be wise to enact such ambitious tax reforms. Restoring the personal exemption would be an important and necessary step to clarify the current tax dilemma, and providing more limited tax relief would be more prudent than the changes proposed by the bills, with more bearable financial consequences.

Legislative Analyst: Drew Krogulecki

### **FISCAL IMPACT**

#### **House Bill 5420 (H-4)**

The bill would reduce General Fund revenue from currently forecasted amounts by an unknown but significant amount in fiscal year (FY) 2017-18 and FY 2018-19, depending on when the bill's changes became effective, by approximately \$168.6 million in FY 2019-20, and by a lesser amount that would decline each subsequent fiscal year--reaching zero by approximately FY 2026-27.

The reduction in revenue during FY 2017-18 and FY 2018-19 would depend on when the bill was effective. If the changes for tax year 2018 were made retroactive, and effective beginning January 1, 2018, and income tax payments and withholding tables were adjusted to reflect that retroactivity, the bill would reduce FY 2017-18 General Fund revenue by approximately \$66.8 million and FY 2018-19 revenue by \$132.7 million. However, if the bill's changes were not effective until April 1, 2018, revenue in FY 2017-18 would be reduced by approximately \$44.5 million; however, the revenue reduction in FY 2018-19 would increase to approximately \$155.0 million.

The impact of the bill would decline after FY 2019-20 because the difference between the value of the personal exemption under the bill and under current law would decline. Depending on the inflation rate over time, the difference would be expected to be eliminated by approximately FY 2026-27.

Under current law, approximately 23.8% of gross income tax revenue is earmarked to the School Aid Fund; and an increase in the personal exemption would lower School Aid Fund revenue. However, the bill would increase the earmark of revenue to the School Aid Fund to offset the loss. As a result, if the bill lowered FY 2018-19 revenue by \$155.0 million, the earmark of revenue to the School Aid Fund would increase by \$36.9 million, so the entire \$155.0 million in lower collections would reduce General Fund revenue.

In addition to the bill's impact relative to current revenue forecasts, the bill would reduce General Fund revenue relative to current law by approximately \$1.1 billion in FY 2017-18, and approximately \$1.4 billion in FY 2018-19. The revenue loss relative to current law would increase in subsequent fiscal years. These additional losses would reflect that the Federal tax reform legislation adopted in December 2017 would effectively eliminate the personal exemption under the Michigan individual income tax, thereby increasing revenue by approximately \$1.1 billion in FY 2017-18 and \$1.4 billion in FY 2018-19 (and additional amounts in future fiscal years). The bill's changes regarding the definition of "dependent" are meant to effectively decouple Michigan's current individual income tax provisions for dependents from the Federal tax reform changes. However, current revenue estimates do not account for the impact of Federal tax reform on Michigan's statutory tax provisions. Consequently, while the bill's changes to the definition would lower revenue relative to current law, the changes would not lower revenue relative to current revenue estimates.

While the changes in the definition of "dependent" would not lower revenue below current revenue estimates, the bill also would increase the personal exemption amount above the levels that would exist if the bill only decoupled Michigan tax provisions from the Federal tax reform legislation. As a result, the bill also would reduce revenue relative to currently forecasted levels.

### **House Bill 5421**

The bill would have no impact on State revenue or expenditure. However, the bill would prevent an increase in local unit revenue resulting from the passage of Federal tax reform legislation in December 2017. Without the enactment of this proposal, the Federal tax reform legislation adopted in December 2017 will effectively eliminate the personal exemption under city income taxes. Based on data from 2014, approximately 1.5 million exemptions were claimed with cities under their income tax ordinances (approximately 600,000 resident returns and approximately 900,000 nonresident and part-year resident returns). Statute requires city income tax ordinances to provide a personal exemption of at least \$600 per allowable exemption. Several cities, including Battle Creek, Grayling, Hudson, Ionia, Portland, Saginaw, and Springfield, provide exemptions that exceed \$600. Based on 2014 data, the increase in local unit revenue attributable to the Federal changes will be approximately \$9.9 million under existing law. Thus, the bill would prevent local unit revenue from increasing by \$9.9 million per year.

### **House Bill 5422 (H-1)**

The bill would reduce General Fund revenue by approximately \$200.4 million in fiscal year 2018-19. Due to changes in age demographics, the revenue loss would increase in future years, with the loss totaling \$205.4 million in FY 2019-20 and \$210.3 million in FY 2020-21.

Fiscal Analyst: David Zin

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.