

**SENATE FISCAL AGENCY
MEMORANDUM**



DATE: September 14, 2005
TO: Members of the Senate
FROM: Jay Wortley, Senior Economist
David Zin, Economist
RE: Business Tax Package Passed by the House

On August 31, 2005, the House of Representatives passed a package of bills that proposes to change several taxes on Michigan's businesses. This package of bills is dominated by a net reduction in the single business tax, but also includes some revenue generating changes to the sales and use taxes, and the tax paid on commercial rental property, as well as a tax amnesty program. It is estimated that these proposed tax changes would result in a net tax reduction of \$142.0 million in FY 2005-06 and by FY 2008-09, the net reduction would grow to an estimated \$350.0 million. Given that most of the proposed tax changes are to the single business tax and that under current law, and this proposed package of bills, the single business tax is scheduled to be repealed beginning January 1, 2010, it is estimated that the size of the net tax reduction would fall to \$102.0 million in FY 2009-10 and that a tax increase of \$48.0 million would result in FY 2010-11. This memo provides a summary of the major tax changes proposed in this package of bills and their estimated fiscal impacts.

Single Business Tax Proposed Changes

- **Tax Rate in 2007 and 2008: H.B. 5108 (H-3).** The single business tax rate would be reduced by 0.1 percentage point in both 2007 and 2008. These cuts in the tax rate would be in addition to any cuts in the rate due to the current provision in the law that lowers the tax rate 0.1 percentage point for a calendar year following a fiscal year in which there is at least \$250.0 million in the Budget Stabilization Fund. Therefore, under this proposal the single business tax rate would be reduced from the current 1.9% to at least 1.8% in 2007 and to 1.7% in 2008 and after.
- **Tax Rate in 2009 and After: H.B. 5108 (H-3).** This proposal would also create a new trigger for lowering the single business tax rate. Beginning in 2009, the tax rate would be lowered by 0.05 percentage point each calendar year when the single business tax revenue estimate adopted at that year's May Consensus Revenue Estimating Conference predicts that single business tax revenue will be up at least \$80.0 million in the current fiscal year compared with the previous fiscal year. This "trigger" would only be allowed to reduce the tax rate four times, for a total reduction in the tax rate of 0.2 percentage points; however, given that under current law the single business tax is scheduled to be repealed as of January 1, 2010, this provision could only possibly trigger a rate cut of 0.05 percentage point in 2009.
- **Health Care Insurance Costs: H.B. 5108 (H-3).** The amount of health care insurance costs paid by employers that are included in the base of the single business tax is currently being reduced. Under current law, 5.0% of these costs were exempt from the

tax base in 2004, and this exemption increased to 20.0% in 2005. This exemption will increase to 40.0% in 2006 and to 50.0% in 2007 and after. Under the House plan, this exemption would increase to 62.5% in 2008, 75.0% in 2009, 87.5% in 2009, and 100% in 2010 and after (although the SBT will be repealed in 2010).

- **Apportionment Factor: H.B. 4973 (H-2).** Under current law, the apportionment factor used to determine a multi-state business' tax base attributable to activity in Michigan is based on the weighted average of the percent of their overall sales, property, and payroll located in Michigan and the weights are 90.0% on sales, and 5.0% on property and payroll. The House plan would increase the weight on the sales factor to 95.0% and reduce the weights on property and payroll to 2.5% in 2006 and 2007, and for tax years beginning in 2008, apportionment would be based entirely on the sales factor.
- **Small Business Credit: H.B. 5108 (H-3).** Currently, one of the requirements for being eligible for the small business credit is that a small business must not pay any of its officers or shareholders more than \$115,000 during the tax year, and in fact the credit is phased out for small businesses that pay an officer or shareholder between \$95,000 and \$115,000. The House plan would increase this officer/shareholder compensation limit to \$175,000 beginning in 2007. However, there appears to be an error in the House plan, in that it still phases out the credit for officer/shareholder compensation levels between \$95,000 and \$115,000 but provides a 100% credit for levels above \$115,000. It is highly unlikely this is their intention because under these parameters, a small business that pays an officer \$95,000 would receive 100% of their small business credit, a small business that pays an officer \$115,000 would receive 20.0% of their small business credit, and small businesses paying an officer from \$116,000 to \$175,000 would receive 100% of the credit.
- **Alternative Tax Rate Method: H.B. 5108 (H-3).** The single business tax offers an alternative tax computation designed to help small, low-profit businesses by converting the tax to a tax on owners' earnings. Currently the tax rate for this alternative tax method is 2.0%. Under the House plan, this alternative tax rate would be reduced to 1.8% in 2008, 1.6% in 2009, and 1.4% in 2010 (even though the single business tax will be repealed in 2010).
- **Gross Receipts Deduction: H.B. 5108 (S-3).** Under current law, a taxpayer may deduct the amount by which their adjusted tax base exceeds 50.0% of gross receipts. Under the House plan, the deduction is reduced by increasing the gross receipts percentage from 50.0% to 52.7% in 2007 and to 56.0% in 2008 and after.
- **Excess Compensation Deduction: H.B. 5108 (S-3).** Currently, a taxpayer may reduce their adjusted tax base by the percentage that compensation divided by the tax base exceeds 63.0%. This deduction would be reduced under the House plan by making the deduction equal to the percentage that compensation divided by the tax base exceeds 66.0% in 2007 and 70.0% in 2008 and after.
- **Industrial Personal Property Tax Credit: H.B. 4972 (H-2).** The House tax plan proposes to create a new tax credit for property taxes paid on industrial personal property. The size of this credit would vary from 15.0% to 50.0% of the property taxes

paid on industrial personal property and the amount a taxpayer could claim would depend on when the personal property was originally purchased, as outlined in Table 1.

Table 1

Proposed Tax Credit for Property Taxes Paid on Industrial Personal Property: H.B. 4972 (H-2)						
Tax Credit - Percent of Property Taxes Paid in Calendar Year						
Year Property Purchased	2006	2007	2008	2009	2010	2011 And After
2006	---	50.0%	30.0%	25.0%	20.0%	20.0%
2007	---	---	50.0%	30.0%	25.0%	20.0%
2008	---	---	---	20.0%	20.0%	20.0%
Other than 2006-08	15.0%	15.0%	15.0%	20.0%	20.0%	20.0%

- **Tax Credit for All Personal Property Taxes: H.B. 4972 (H-2).** The House plan would also create a credit for all personal property taxes that would be triggered on and off by the same trigger that would reduce the tax rate beginning in 2009. Under the provisions for this credit, the earliest this credit would take effect would be in 2014. Given that the single business tax is due to expire in 2010 this credit would never become effective.
- **Apprenticeship Tax Credit: H.B. 5098 (H-3).** The apprenticeship tax credit would be repealed effective January 1, 2006.
- **Tax Implementation Policy: H.B. 5108 (H-3) & H.B. 5098 (H-2).** The Department of Treasury's current interpretation and enforcement of current law regarding the ability of consolidated returns to carry forward a credit or loss and the ability of partnerships to be eligible for the small business credit would be codified into law, but only prospectively beginning in 2006. As a result, some businesses would be eligible for refunds for tax payments made for the 2005 and prior tax years.

Property Tax Proposed Changes

- **Commercial Rental Property: H.B. 5096 (H-2) & H.B. 5097 (H-3).** Commercial rental property would be exempt from the general property tax, and instead be subject to a new specific tax, beginning in 2006. This specific tax would be applied at the same millage rate as the property tax and would be distributed in exactly the same way as the property tax. Under this proposed specific tax, the value of the commercial rental property would be allowed to be adjusted as occupancy changes -- down if occupancy decreases and then back up if occupancy increases. The courts have ruled that under the current property tax, the Constitution prohibits increases in value due to increasing occupancy rates.

Sales and Use Tax Proposed Changes

- **Driver Education Vehicles: H.B. 5106 (H-2) & H.B. 5107 (H-2).** Motor vehicles purchased or leased by a public or parochial school for use in driver education courses would no longer be exempt from sales or use taxes beginning October 1, 2005.
- **Inmate Purchases: H.B. 4980 (H-2).** Tangible property purchased by inmates in a correctional institution would no longer be exempt from the sales tax effective October 1, 2005.
- **Telecommunication Services: H.B. 5107 (H-2).** Effective October 1, 2005, wide-area telecommunication services, interstate private networks, and international calls would become subject to the use tax just like intrastate and interstate long distance calls are under current law.

Tax Amnesty

- A tax amnesty program would be implemented beginning January 1, 2006 through February 28, 2006: H.B. 5095 (H-2).

Fiscal Impact

The estimated fiscal impacts of these proposed tax changes are summarized in Table 2 (attached). Reflecting the fact that many of the proposed changes are phased in over several years, it is estimated that during the first four years of these changes, their collective impacts would result in progressively larger net revenue losses of \$142.0 million in FY 2005-06, \$192.0 million in FY 2006-07, \$312.0 million in FY 2007-08, and \$350.0 million in FY 2008-09. Given that under current law the single business is scheduled to be repealed beginning January 1, 2010, and that none of these bills propose to eliminate this repeal, the single business tax would only be in effect during the first three months of FY 2009-10. As a result, it is estimated that the net revenue loss under these bills would fall back to \$102.0 million in FY 2009-10. By FY 2010-11, the single business tax would be repealed for the entire fiscal year and as a result the only components of this package of bills that would still be in effect would be the revenue generating changes to the sales and use taxes, and the restructured tax on commercial rental property. As a result, it is estimated that this package of bills would result in a tax increase of \$48.0 million in FY 2010-11.

We hope you find this information on the House tax package helpful. If you have any questions or need any additional information, please call either of us at 3-2768.

/kjh

Attachment

c: Gary S. Olson, Director
Ellen Jeffries, Deputy Director

Table 2

**House Business Tax Package - Estimated Fiscal Impact*
(Millions of Dollars)**

Tax and Proposed Change	Bill	Fiscal Year					
		FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
Single Business Tax Rate							
Reduce tax rate 0.1 percentage point in 2007 & 2008.	H.B. 5108	\$0	(\$78)	(\$187)	(\$220)	(\$57)	\$0
Allow for an additional four 0.05 percentage point tax rate cuts based on May SBT consensus estimate trigger.	H.B. 5108	0	0	0	0	0	0
Increase small business credit by increasing officer pay maximum and decreasing alternative tax rate.	H.B. 5108	(16)	(14)	(59)	(79)	(69)	0
Phase out all health care insurance costs from the tax base.	H.B. 5108	0	0	(9)	(13)	(5)	0
Reduce the gross receipts and excess compensation deductions.	H.B. 5108	0	49	118	139	36	0
Create a new tax credit for industrial personal property taxes.	H.B. 4972	(117)	(150)	(163)	(169)	(40)	0
Create a new tax credit for all personal property taxes.	H.B. 4972	0	0	0	0	0	0
Phase in a 100% sales apportionment factor.	H.B. 4973	(22)	(22)	(46)	(48)	(13)	0
Eliminate apprenticeship credit after 2005.	H.B. 5098	1	1	1	1	1	0
Codify prospectively certain tax implementation policy.	H.B. 5108	(41)	0	0	0	0	0
Subtotal Single Business Tax		(\$195)	(\$214)	(\$345)	(\$389)	(\$147)	\$0
Property Tax							
Commercial rental property - specific tax replaces property tax.	H.B. 5096 & 5097	\$7	\$11	\$16	\$22	\$27	\$30
Sales and Use Taxes							
Eliminates exemption for driver education vehicles	H.B. 5106 & 5107	\$1	\$1	\$1	\$1	\$1	\$1
Eliminates exemption for inmate purchases	H.B. 4980	1	1	1	1	1	1
Extends tax to international and interstate private network calls.	H.B. 5107	14	14	15	15	16	16
Subtotal Sales and Use Taxes		\$16	\$16	\$17	\$17	\$18	\$18
Tax Amnesty							
Initiate a tax amnesty program in FY 2006.	H.B. 5095	\$30	(\$6)	\$0	\$0	\$0	\$0
Total Fiscal Impact		\$(142)	\$(192)	\$(312)	\$(350)	\$(102)	\$48

*As passed by the House on August 31, 2005.

Source: Compiled and estimated by the Senate Fiscal Agency based on information from the Department of Treasury and the House Fiscal Agency.