

State Notes

TOPICS OF LEGISLATIVE INTEREST

Winter 2015



A Primer on Certificated Credits under the Michigan Business Tax

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Introduction

State General Fund/General Purpose (GF/GP) revenue estimates for fiscal year (FY) 2013-14, FY 2014-15, and FY 2015-16 were revised downward at the January 2015 Consensus Revenue Estimating Conference. The revenue decrease was due primarily to the larger-than-expected amount of refunds issued for the Michigan Business Tax (MBT). Although the Michigan Business Tax Act was repealed on January 1, 2012 for most business tax filers, some businesses continue to file MBT returns in order to claim refundable tax credits. While new MBT tax credits have not been issued since the MBT Act was repealed, previous tax credit agreements are still in place and have been amended, and the improving economy has made it more likely that eligible businesses can complete the investments and job increases required to claim credits; thus, the amount of credits claimed by eligible businesses has continued to grow. This article reviews the tax credits that are now being claimed, summarizes the recent history of business taxes in Michigan that led to the award and continuation of these tax credits, discusses reasons for the volatility in the amounts being claimed, and describes possible options for limiting the impact of these tax credits on GF/GP revenue.

Background

Public Act 24 of 1995 created the Michigan Economic Growth Authority (MEGA) tax credit program to attract, retain, create, and increase job and capital investment in Michigan. The Michigan Economic Growth Authority tax credits are refundable tax credits, which means that if the credit amount is greater than the tax owed, the State will pay the cash difference to the company as a refund, whether or not the company has any tax liability. At its inception, the program authorized the award of credits against the Single Business Tax (SBT) to approved companies in targeted industries that met criteria for job creation and investment.

The business tax structure in Michigan has changed dramatically since the MEGA credit program was first enacted. The Single Business Tax was replaced effective January 1, 2008, by the MBT. The Michigan Business Tax raised an amount of revenue similar to the SBT revenue and allowed previously issued tax credits to continue to be claimed. Under the MBT, new MEGA credits also continued to be approved by the MEGA board through the end of 2011.

Effective January 1, 2012, the MBT was repealed (for most taxpayers) and replaced with the Corporate Income Tax (CIT). The Corporate Income Tax generates substantially less revenue from business taxpayers than either the SBT or MBT raised. Under the MBT, businesses (including corporations, partnerships, S-Corporations, sole proprietorships and limited liability companies) were taxed at a rate of 4.95% on business income and 0.8% on gross receipts, although a 21.99% surcharge effectively made the rates 6.04% on business income and 0.98% on gross receipts. Under the CIT, only corporations are taxed and the rate is 6.0% of corporate income. The Corporate Income Tax legislation permitted MEGA credit holders to choose to switch to the CIT and forego the MEGA credits or to continue to file under the MBT Act and claim credits, giving companies the option to continue to benefit from refundable credits for which they were eligible. Approximately 200 taxpayers continue to file MBT returns in order to claim MEGA credits and other certificated



credits. Because of the value of these credits, it is likely that these businesses will continue to do so until they have redeemed all of the MEGA tax credit certificates for which they are eligible.

The 2011 legislation that effectively eliminated the MBT for most taxpayers also prohibited the issuance of new tax credit awards after January 1, 2012. Additional legislation created a new incentive program beginning in FY 2011-12 that functioned by issuing grants and loans instead of tax credits. However, because some MEGA awards may be claimed for as long as 20 years, companies are expected to continue to be eligible for credits through 2032. Furthermore, FY 2031-32 will not be the last fiscal year that payments on these credits will be made and the MBT Act will not officially be repealed until all credits have been redeemed.

Credits were issued by the MEGA board from 1996 through 2011. Claims of credits by companies started in 1996. Based on the potential credits that have been awarded, claims of credits can continue through 2032. Even though new credits cannot be issued, the Michigan Strategic Fund board can amend previously issued credits, which can either increase or decrease the refund amount.

Michigan Business Tax Credits

The 2011 legislation preserved a variety of different types of credits under the MBT. In addition to credits issued in the MEGA program, certificated credits that may be claimed include the Early Stage Venture Capital credit, brownfield redevelopment credits, credits for photovoltaic technology, anchor company payroll credits, Federal government employment credits, anchor company taxable value credits, polycrystalline silicon manufacturing credits, credits for high-power energy batteries, hybrid technology research and development credits, media production credits, media infrastructure credits, historic preservation credits, renaissance zone credits, NASCAR Speedway credits, and farmland preservation credits. For most of these credits, the credit awards were approved by the Michigan Economic Growth Authority board, which was located within the Michigan Strategic Fund, and staffed by the Michigan Economic Development Corporation since Executive Order 1999-1. The MEGA board was dissolved by Executive Order 2012-9, which moved all of the responsibilities of the MEGA board to the MSF board. No new credits have been issued by the MSF board since the end of 2011, although credit agreements have been amended.

Generally, MEGA credits involve some sort of *quid pro quo* arrangement in which the taxpayer is required to accomplish certain goals in exchange for the credits. While awards can be for as long as 20 years, distinct criteria generally are specified for each individual year during that period and the first year of the award period may be several years after the formal award agreement is approved. The criteria vary by the nature of the credit or program, but often include provisions regarding creating or maintaining a certain number of jobs and/or making investments in plants and equipment of at least a specified level, whether in terms of developing new facilities or rehabilitating old facilities. Taxpayers may fail to qualify for a credit in one year but then later qualify for the credit, while others may never qualify for the credit. The nature of the agreements, in which the taxpayer is promised some sort of tax compensation in exchange for pursuing specified economic activities, has resulted in the development of policies to preserve the credits even as the tax structure has changed.

In the debate over the value of economic development incentives, an issue that often arises is whether an incentive is generating new economic activity or merely subsidizing activities that otherwise would have occurred. Evaluating this aspect of incentives is very difficult for even a single



year, let alone when done for awards that may have been made almost two decades ago. An incentive may make no difference or all of the difference in a project, by raising the return on a project to a level at which the project can proceed. The following example illustrates this point: Assume a taxpayer is considering a business investment and requires a 5.0% return on the investment to pursue it. Also assume that the State offers an incentive that will improve the rate of return on the project by 2.0%. Three scenarios can be considered based on three different states of the economy. Assuming the taxpayer's forecast of the market is correct, the following three cases describe the potential outcome if, absent the incentive, the taxpayer will receive a return of:

- a) 1.0%
- b) 7.0%
- c) 4.0%

In scenario a), the economy will return 1.0% on the investment and the tax incentive will improve that return to 3.0%. The taxpayer will not pursue the investment because even with the incentive, the project will fail to generate sufficient returns. In this case, the incentive made no difference to the business decision and ultimately would not cost the State any revenue.

In scenario b), the economy will return 7.0% to the taxpayer and the incentive will boost that return to 9.0%. The taxpayer will pursue the investment and, because of the incentive, will receive a return of 9.0% rather than 7.0%. In this case, the incentive did not change taxpayer activity but did cost the State revenue, which simply made the firm's activities more profitable than they otherwise would have been.

In scenario c), the economy will return 4.0% on the investment and the taxpayer would not pursue the investment without the incentive. However, the incentive raises the return on the project to 6.0%, now making it profitable for the taxpayer to proceed. In this case, the incentive will reduce State revenue, but will also generate economic activity that would not otherwise occur.

An important caveat to mention with economic development incentives is that there also may be cases in which the incentive does not affect *whether or not* the taxpayer pursues the investment but affects *where* the taxpayer pursues the investment. It is not difficult to locate media articles describing states or local units that effectively bid against each other in order to attract a business investment, or to find businesses that attempt to pit governments against each other in such bidding. In these circumstances, a condition such as scenario b) might exist, but if one state is offering an incentive that improves the rate of return by 2.0% and another state offers an incentive that improves the return by 4.0%, the business is going to pursue the activity regardless of whether an incentive is offered by any state, but will more than likely pursue the investment in the second state in order to maximize its return.

Mechanics of the MEGA Credit Process

To qualify for and receive a MEGA credit, businesses are required to go through a number of steps, listed in [Figure 1](#). First, a business must undergo an application process and receive approval of a credit agreement by the MEGA board. Second, an approved company must complete the required investment and job creation. Third, in order to receive the financial benefit of the credit, the business must apply for a credit certificate. Fourth, after review of the application, the MSF/MEDC issues a credit certificate. Fifth, the company then submits the certificate, with an MBT return, to the Department of Treasury. If the company has already submitted a return for that tax year, the



company will submit an amended return. The Department of Treasury may have audit issues that must be resolved before it issues any refund. Finally, once approved by Treasury, the business receives the credit. Businesses have flexibility on when they can redeem the credit certificates. In some cases, the tax returns are due before credit certificates have been received and the business must file an amended tax return. Businesses also can amend multiple tax returns in the same year. With reviews and audits possible at each stage, the time frame can be several years from when a business first applies for the credit to when it receives the payment, explaining why payments for redeemed tax credits could continue well beyond FY 2031-32.

As of November 2014, the MEDC estimate of the amount of MEGA credits that were awarded for the years 2015 through 2032 but not yet redeemed totaled \$6.5 billion, up \$1.6 billion from an estimated \$4.9 billion in March 2011, as shown in [Figure 2](#). The increased value of awards reflects new awards made during 2011 and amendments to agreements that were made before 2011. Additionally, the MEDC has made changes in certain calculations used to estimate future credit amounts.

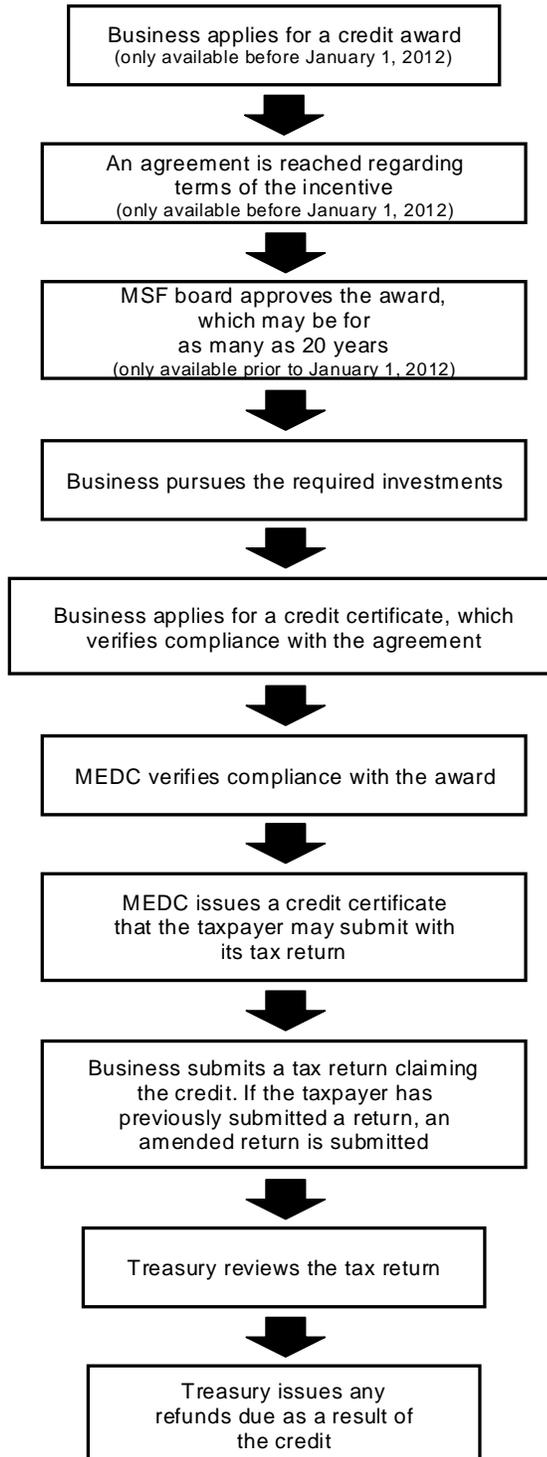
According to the MEDC, the \$1.6 billion change in the estimated value of MEGA awards from March 2011 to November 2014 represents approximately \$73.0 million in new awards made during 2011, approximately \$391.0 million in increased awards attributable to amendments to previous awards, and approximately \$1.1 billion from the revised calculations made to estimate the value of the awards. The majority of these revisions affect job retention credits, and the value of those credits depends heavily on the compensation (wages, health care costs, etc.) paid to retained employees. Apparently, earlier estimates not only assumed an average compensation rate on retained jobs that was too low, but also assumed no growth in compensation rates over the 20-year period of the awards. While the MEDC has updated the projected costs to reflect compensation costs submitted under recent claims, the projections continue to assume no growth in future years from those revised levels.

As a result, the data illustrated in [Table 1](#) and [Figure 2](#) likely understate the future value of both the awards and the projected claims. It is unknown what portion of the award amounts reflect these job retention credits, but if 50% of the amounts shown represent job retention credits and compensation costs rise 5.0% per year, the total value of the awards is approximately \$1.7 billion more than shown in [Table 1](#), and the projected cost of the credits is approximately \$1.4 billion higher. If the retention credits are 70% of the total and compensation costs average 8.0% growth, the value of the awards is approximately \$4.2 billion higher than shown in the table, and the value of projected claims is approximately \$3.5 billion higher.

Furthermore, predicting the number and amount of credits that will be redeemed is difficult, and generally depends much more on economic factors specific to the taxpayer than on general economic conditions forecasted by the Consensus Revenue Estimating Conference. Previously, estimates assumed that approximately 35.0% of awards would ultimately be claimed, while more recent estimates have been adjusted to reflect taxpayer claims over the last few years and predict that, on average, approximately 75.0% of the award amounts will be redeemed. The combination of timing issues in the credit process, amendments to credit agreements and calculations, and changes in redemption rates makes it difficult to predict the amount of redeemed tax credits that will be paid in a single budget year.



Figure 1
MEGA Credit Process



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Figure 2

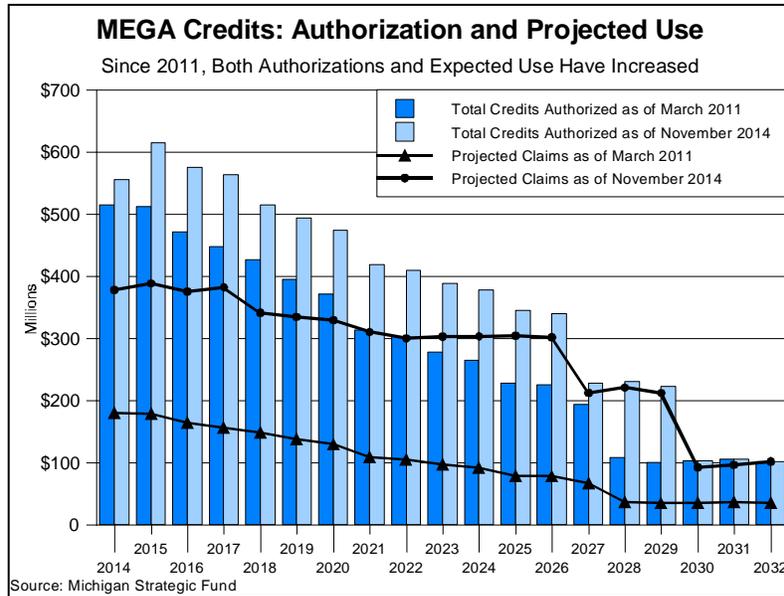


Table 1

Approved MEGA Awards and Projected Credit Values - 2015-2032 (Dollar Amounts in Millions)		
Year	Amount	Credit Value
2015	\$615.1	\$388.2
2016	575.6	375.2
2017	563.4	382.4
2018	514.3	341.5
2019	493.1	334.6
2020	474.1	329.0
2021	418.8	310.3
2022	409.0	300.0
2023	388.1	302.5
2024	377.6	303.5
2025	344.4	304.3
2026	340.3	302.2
2027	227.6	212.2
2028	230.0	220.8
2029	222.2	212.3
2030	102.9	92.4
2031	105.4	96.2
2032	102.1	102.1
Total	\$6,504.0	\$4,909.7

Note: Projected credit values represent MSF/MEDC projections and differ in both magnitude and content from MBT estimates made as part of the Consensus Revenue Estimating process. See text for details.

Source: Michigan Strategic Fund/Michigan Economic Development Corporation, November 2014.

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Michigan Business Tax Credits and the Impact on State Revenue

The January 2015 Consensus Revenue Estimating Conference (CREC) adopted a revenue forecast for the General Fund in FY 2015-16 that was \$532.1 million less than forecasted in May 2014. Net MBT revenue for FY 2015-16 was estimated at a negative \$807.4 million, which is \$350.9 million lower than what was predicted during the May 2014 CREC. While the estimated impact of MEGA awards is expected to decline in the future as credits continue to be redeemed, net negative MBT is expected to be a significant drain on General Fund revenue for at least another decade.

Table 1 displays approved credits and projected redemptions for 2015 through 2032. These figures represent award amounts and the associated projected use for each year based on estimates of when and by how much a business meets the specified criteria. As indicated earlier, timing issues significantly affect when the credits will actually be paid and it is likely that credits will continue to be claimed well past the 2032 horizon shown in the table. Beyond the timing issues, net MBT revenue is likely to differ substantially from the projected credit amounts because some businesses will exhibit tax liabilities that offset the projected credit amounts, firms may file tax returns that are later amended, and there are MBT revenue issues not related to MEGA credits. (For example, despite the repeal of the SBT Act after tax year 2007, the State still processes millions of dollars in payments, refunds, and penalties from the SBT.)

Table 2 illustrates the magnitude of the timing issues that can affect the differences between a given year's projected award amounts and when revenue is affected. The majority of refunds paid during FY 2013-14 reflected credits claimed for return years that began in either 2011 or 2012, although almost 5.0% of the refunds were paid for return year 2008. Return year 2013, the most recently completed full year for returns that would have been received during FY 2013-14, represented approximately 12.0% of the refunds paid during FY 2013-14. If the comparison includes the portion of refunds received but not yet paid that are attributable to return year 2013, the share actually declines to 9.0%. As a result, while Table 1 illustrates awards for future years, not only is there a delay between the award year and the year in which the refunds are paid, but multiple years of awards can occur within a single fiscal year.

Table 2

FY 2013-14 Michigan Business Tax Refunds by Return Year (Dollar Amounts in Millions)		
	Dollar Amount	Share of Total
<u>Refunds Paid During FY 2013-14, by Return Year</u>		
2008.....	\$34.1	4.7%
2009.....	65.5	9.0
2010.....	89.9	12.3
2011.....	213.4	29.3
2012.....	186.8	25.6
2013.....	88.5	12.1
2014.....	50.5	6.9
Total Refunds Paid	\$728.8	100.0%
Accrual for Claims Received by Treasury But Not Yet Paid..	\$341.5	N/A
Refunds Already Booked to Prior Years	(\$267.2)	N/A
Net MBT Refunds with Accruals	\$803.1	
Note: Return year means all returns beginning in that calendar year. A firm with a tax year running from August 2009 to July 2010 would be included in return year 2009. N/A = Not Applicable.		

Source: Michigan Department of Treasury

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As discussed earlier, the SBT and the MBT generated similar revenue totals and the CIT generates substantially less than either the SBT or the MBT. The reasoning behind keeping certificated credit holders under the MBT concerned the magnitude of the credits a business would receive relative to its tax liability. For example, if a taxpayer usually experienced an MBT liability of \$10.0 million and received a credit award of approximately \$5.0 million, the perception was that it would not be in the State's interest to allow the taxpayer to continue to claim the \$5.0 million credit if the taxpayer were now filing under a new law under which the tax liability would be something lower, for example, \$4.0 million. Although the State would be forgoing \$5.0 million in both cases, under the MBT the State would still receive \$5.0 million while under the CIT the State would issue a \$1.0 million refund.

The problem for State revenue is that the logic used to justify keeping taxpayers with certificated credits under the MBT is difficult to extrapolate to the State when taxpayers are viewed as an aggregate. In FY 2010-11, the State paid \$334.7 million in MBT refunds, a portion of which was refunds for what would later become certificated credits. However, those refunds were offset by more than \$2.4 billion in MBT revenue, leaving the State with net positive MBT revenue of just under \$2.1 billion. In comparison, in FY 2013-14, the State paid \$803.1 million in MBT refunds that was offset by \$79.8 million of MBT revenue and \$906.4 million in CIT revenue. When combined with refunds paid under the SBT, net business tax revenue under the CIT, MBT, and SBT totaled \$137.6 million in FY 2013-14. The decline in net business tax revenue since the \$2.1 billion generated in FY 2010-11, the last full year of MBT revenue, reflects the approximately \$1.6 billion tax cut from moving to the CIT as well as increases in MBT credits.

Not only have MBT refunds increased due to changes in the State's incentives but the credits are offset by a much smaller revenue stream. In FY 2015-16, the net business tax revenue from the CIT, MBT, and SBT is projected to total \$159.3 million, with \$976.7 million in CIT revenue largely being offset by \$807.4 million in negative net MBT revenue. These credits reduce General Fund revenue and represent a significant portion of the General Fund available in any given year. Based on FY 2013-14 revenue, MBT credits reduced General Fund revenue by \$807.3 million, or approximately 9.0%.

Under the current forecast, certificated credits under the MBT are predicted to equal 7.7% of General Fund revenue in FY 2014-15, and 8.8% in FY 2015-16, as shown in [Figure 3](#). As a result, significant swings in the value of MBT credits claimed in any given year can have a significant impact on General Fund revenue. As indicated above, certificated credits include both MEGA credits and a number of other credits; however, the Michigan Strategic Fund's estimate of MEGA credit claims indicates that MEGA credits represent a significant component of the credits that will reduce General Fund revenue, as [Figure 4](#) illustrates.



Figure 3

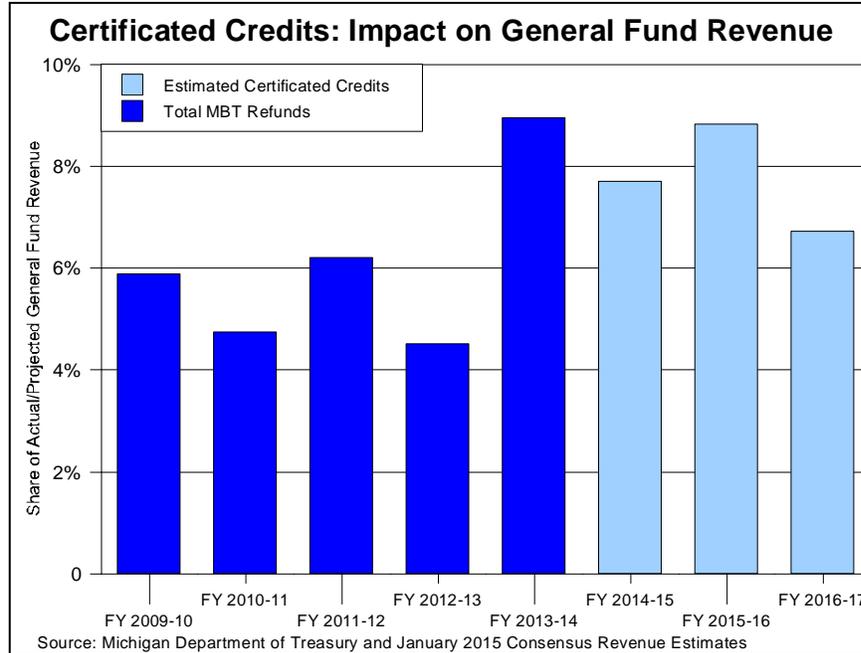
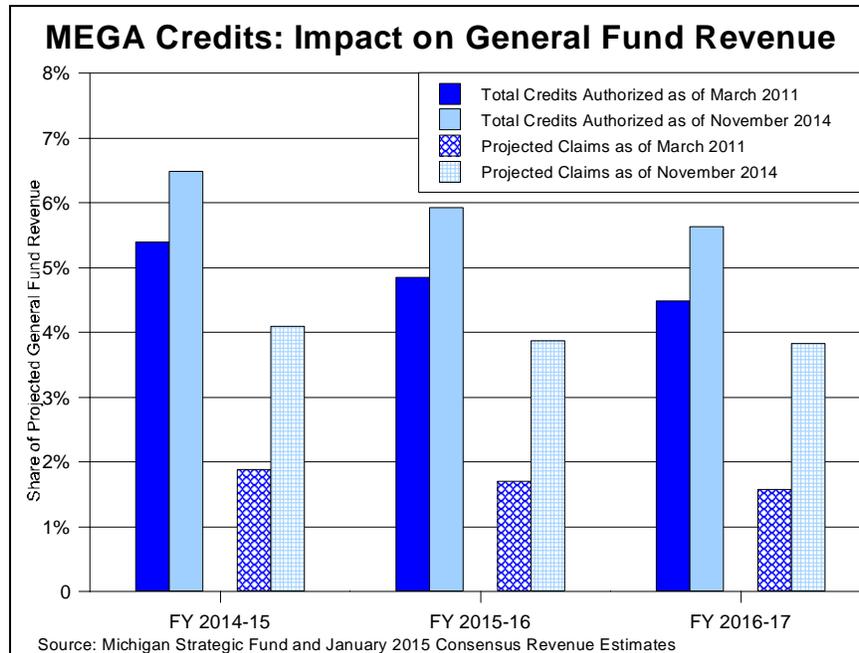


Figure 4





Making Revenue and Credits More Predictable

There are written agreements between the Michigan Strategic Fund and businesses regarding the payment of credits. However, there may be ways to limit both the volatility and magnitude of certificated credits in a given year, as well as ways to prevent the State's total exposure to revenue losses from increasing. The following discussion is not meant to represent a comprehensive list of options, or to suggest that any of these options has been investigated with respect to its economic, legal, or political ramifications. The options mentioned in the following paragraphs are provided as a reference point for the types of actions that could accomplish specific goals related to State revenue.

First, the State could alter the manner in which credits are paid. For example, the State could convert the credits from refundable to nonrefundable and/or allow them to be carried forward to offset liabilities in future tax years. Several certificated credits were originally nonrefundable credits. If the credits were no longer refundable but carried forward, their dollar value would be eroded by inflation and most affected taxpayers would need to continue filing the MBT well past FY 2031-32. However, eliminating refundability would reduce both the magnitude of any changes in net MBT revenue and the degree to which total net MBT revenue would be negative. Based on limited data from tax year 2012, it appears that such a change would reduce the impact of the credits by roughly 75.0% each tax year, although it would significantly increase the number of fiscal years that would be affected by the credits.

Another option to alter the manner in which credits are paid could be to limit total payments in a given year. Many of the credits included in the list of certificated credits have at various times been subject to annual limits when claimed while other credits were subject to annual limits when awarded. Credits during a year paid could be limited to a specific sum, such as \$300.0 million, and once the State had paid credits totaling that amount, any additional refunds would earn interest and be paid in future fiscal years and/or carried forward to offset future tax liabilities. Similarly, the State could limit a taxpayer to receiving payment for only one tax year's worth of credits during any one fiscal year.

Second, the State could exert greater control over the credit process, specifically with respect to changes in agreements or other administrative calculations. Much as the State has gained greater control and discretion over economic incentives by shifting the programs from ones based on tax credits to ones based on appropriated expenditures, the State could limit the authority for altering agreements or require the incremental costs of such changes to be paid from current appropriations used for current incentives. The Legislature could even require that outstanding agreements be frozen under their current terms and prohibit amendments.

Third, the State could use or build a reserve to mitigate the impact of swings in credits. Historically, transfers have been made from the Budget Stabilization Fund to provide revenue for a variety of purposes, such as making court-mandated payments and offsetting declining revenue from recessions. Large swings in MBT credits simply represent a specific way in which the budget can be subjected to unpredictable circumstances and stabilization funds generally exist to insulate the budget from such swings. Similarly, just as the Legislature has exhibited concerns about unfunded liabilities in State-sponsored retirement systems, the State could embark on a project to "prefund" outstanding MBT credits.



Conclusion

The Michigan Business Tax continues to have a significant impact on State revenue despite being "repealed" more than three years ago. Furthermore, credits authorized under the MBT are likely to have a significant effect on State revenue for at least another two decades. Despite knowing the number of outstanding credits that have been awarded through 2032, the total value of these awards, the magnitude of payments, and when the credits will be paid are relatively unknown and incapable of being forecasted with any meaningful accuracy. Not only have MBT refunds increased due to changes in the State's incentives but the credits are offset by a much smaller revenue stream. Under the current forecast, certificated credits under the MBT are predicted to equal 7.7% of General Fund revenue in FY 2014-15, and 8.8% in FY 2015-16. As a result, large swings in the value of MBT credits claimed in any given year can have a significant impact on General Fund revenue. Until steps are taken to limit the impact of outstanding economic incentive awards, or until the credits have been exhausted, MBT credits will continue to both reduce General Fund revenue and increase its volatility.