The MBT- Changing Business Taxes in Michigan

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Scott D. Schrager
Director of Legislative Affairs
Michigan Department of Treasury

Setting the Stage

- Single Business Tax (SBT) - a consumption value added tax consisting of income plus compensation plus depreciation plus interest paid with other deductions and adjustments.
- Originally scheduled to expire at the end of 2009.
- Repealed at the end of 2007 by initiative petition adopted by the Legislature in 2006.

Why the SBT was Unpopular

- Taxed businesses previously not subject to tax.
- Unique(except New Hampshire).
- Wasn’t based on ability to pay.
- Additive base labeled it as a tax on items such as compensation and health care.
- Changes over the years made it complicated and inconsistent.

Earliest Proposals

- Governor proposed three part tax with assets, gross receipts and income part of the base; 46% personal property tax reduction for manufacturing and commercial; revenue neutrality.
- Chamber of Commerce proposed mixture of gross receipts and business income tax with 50% reduction of personal property tax for all classes; $ 500 million tax cut.

Things that Mattered along the Way

- Substantial credits for economic activity in the state (compensation, capital investment and R&D).
- Reducing the personal property tax.
- Not having some taxpayers pay for others’ credits.
- Tax pyramiding.
- Winners and losers.

Things that Mattered Along the Way

- Not being different from other states.
- Not being like the SBT.
- Revenue neutrality.
- A tax cut for business.
- Maximizing the number of large taxpayers who paid.

Things Discovered

- An overall tax cut does not mean a tax cut for everyone.
- Multiple bases tend to mitigate liability shifts.
- Two taxes are more trouble than one.
- Those who don’t benefit from credits and exemptions will pay more for those who do.
- Banks and insurers don’t fit well.

House Passed Package

- 6.95% business income tax.
- 0.488% net worth tax.
- Each raised half the revenue.
- Credits for compensation, R&D and capital investment in Michigan.
- 73% personal property tax reduction for manufacturing.
- 46% personal property tax cut for commercial.
- Overall revenue neutrality.
- Unitary filing (Finnegan).

Senate Passed Package

- **0.54% tax on gross receipts minus tangible personal property purchases from other firms applies to firms in excess of $15 million gross receipts.**
- **1.5% business income tax.**
- **25% personal property tax credit for manufacturing and commercial.**
- **$250-$300 million headquarters credit.**
- **$600 million tax cut.**
- **Unitary filing (*Joyce*).**

The Differences Reconciled

- House approach to credits.
- Personal property tax reductions closer to House levels.
- Senate modified gross receipts base.
- Expanded small business treatment, closer to Senate approach.
- Revenue neutrality.
- Unitary with *Finnegan* rule.

Michigan’s New Business Tax

New Tax Base

- Business Income Tax – 4.95% rate.
  - Base includes non-corporate entities.

- Modified Gross Receipts- 0.8% rate.
  - Base is gross receipts less purchases from other firms.
  - Purchases from other firms includes inventory, depreciable property, materials and supplies, and construction payments to a subcontractor.

Special Provisions for Small Businesses

- Firms with less than $350,000 in gross receipts exempt.
- Phased-in for $350,000 to $700,000 in gross receipts, eliminating the “cliff effect.”
- Qualifying firms pay an alternate rate of 1.8% on adjusted business income.
- To qualify for the alternate rate, officer compensation cannot exceed $180,000.
- Gross receipts threshold of $20 million.
- Entrepreneurial credit to promote hiring and investment in Michigan.

Personal Property Tax Reductions

- Combination of credits and exemptions reduce manufacturing personal property taxes by 65%.
- Exemptions reduce commercial by 23%.
- Schools held harmless through school formula; portion of tax earmarked to school aid fund.
- Local government revenues not affected.

Major Credits

- **Compensation Credit: 0.37% of Michigan compensation.**
- **Investment Tax Credit: 2.9% of Michigan investment.**
- **Research and Development Credit: 1.9% of Michigan research and development expenses.**

<u>Credit Limits</u>

- **Sum of compensation credit and investment tax credit cannot exceed 65% of MBT liability before credits.**
- **Sum of all three credits cannot exceed 75% of MBT liability before credits.**

Business Income Tax Base

- Starting point: Federal taxable income from business activity.
- Applies to all entity types.
- S corps and partnerships include in taxable income any income or expense attributed to business activity reported separately to partners or shareholders.

Business Income Tax Base

- **Deduct net earnings from self employment included in federal taxable income unless they are a return of capital.**
- **Add intangibles expenses included in federal taxable income made to related parties not part of the unitary group.**

Gross Receipts Defined

The entire amount received by the taxpayer from any activity whether in intrastate, interstate, or foreign commerce carried on for gain to the taxpayer or others.

Modified Gross Receipts Tax Base

- The tax base is a taxpayer's gross receipts less, "purchases from other firms," before apportionment.
- "Purchases from other firms" means:
  - Inventory acquired during the tax year.
  - Depreciable assets acquired during the tax year.
  - Materials and supplies, including repair parts and fuel.
  - Compensation of personnel supplied to customers of a staffing company.
  - Payments by contractors to subcontractors.

Modified Gross Receipts Tax Base Exclusions

- Amounts received as an agent on behalf of the principal.
- Certain amounts realized from the sale of marketable instruments.
- Receipt of the loan principal by residential mortgage companies.
- Receipts by a professional employer organization of the cost of wages paid under the professional employer arrangement.
- Amounts received by auto dealers subsidizing interest expenses.

Business Income Tax Nexus
Sales of Tangible Personal Property

- *Tangible personal property* (TPP) sales are subject to federal statutory jurisdictional standards (PL 86-272).
- Provides that mere solicitation of TPP sales is insufficient to establish nexus.
- PL 86-272 is not applicable to receipts on “services” or “intangibles,” which are subject to same nexus standard as for modified gross receipts.

Modified Gross Receipts Tax Nexus

- **Taxpayer has a *physical presence* for more than 1 day per tax year,**

OR

- **Taxpayer *actively solicits* sales and has Michigan gross receipts of $350,000 or more. (The department must define *actively solicits* and it shall be applied prospectively.)**

Unitary Business Group Defined

A unitary business group is a group of U.S. persons other than a foreign operating entity, one of which:

- **Owns/controls, directly or indirectly, more than 50% of the ownership interest of the other U.S. persons; and**
- **Has business activities or operations that result in a *flow of value* between or among persons in the business group;**

OR

- **Has business activities or operations that are *integrated with, are dependent upon, or contribute to* each other.**

Apportionment

- Single factor apportionment based on sales.
- Sales Factor Formula: Michigan sales/sales everywhere.
- When at least one person in the group has nexus, all Michigan sales by persons in the unitary group are included in the numerator.
- Sales are sourced to another state if that state has jurisdiction to tax even if that state does not do so.

New Tax Base

- **Insurance Companies – 1.25% tax rate**
  - Base is gross direct premiums written.
  - Retaliatory tax is still in place.
- **Financial Institutions – 0.235% tax rate**
  - Base is value of net capital averaged over 5 years.
  - A financial institution is a bank, bank holding company, certain thrift institutions and savings and loans, and a business other than an insurance company owned by the bank that is part of the unitary group.

Severability Clause

If a final order of a court of competent jurisdiction determines that any provision of this act that provides a deduction, credit, or exemption with respect to employment, person, services, investments, or other activity in the state is unconstitutional or applies to a similar activity outside of the state, that provision shall be severed and the remaining provisions would remain in effect.

Basic Numbers

- SBT raises $1.9 billion, excluding insurance provision and retaliatory taxes.
- New structure finances $1.3 billion in personal property tax relief and economic activity credits on top of completely replacing SBT revenue.
- Revenue is 1/3 business income and 2/3 modified gross receipts.

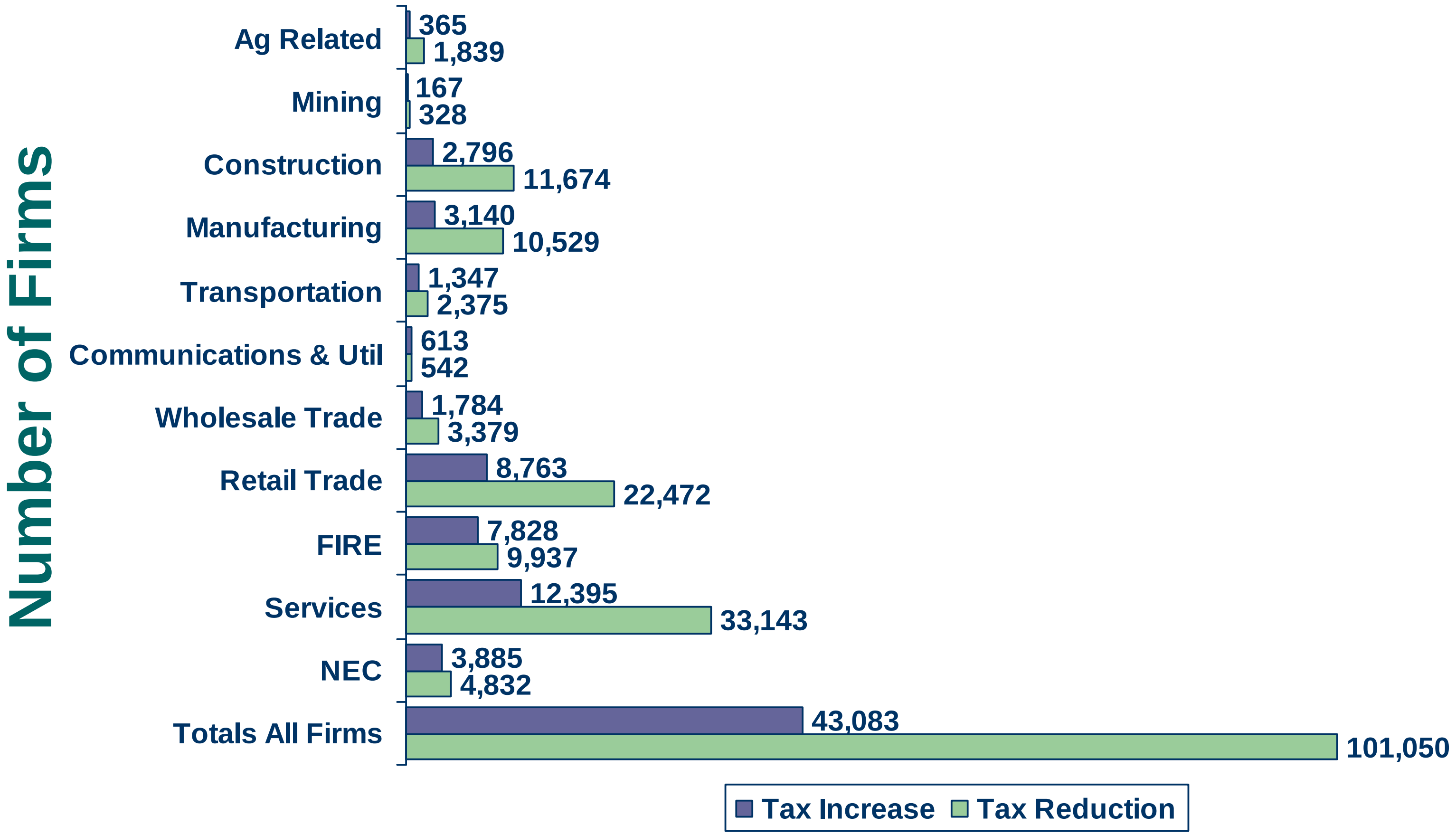
Who Will Pay Less

- Manufacturing firms.
- Small businesses between $10 and $20 million of gross receipts.
- Construction firms.
- Small businesses under $10 million with income to owners over $115,000.
- Michigan multi-state firms.

Who Will Pay More

- Finance, insurance and real estate (FIRE)
- Profitable firms.
- Firms without much personal property.
- Firms that operate in Michigan but have little payroll or property here.

Twice as Many Firms Receive a Tax Reduction



MBT Revenue Limit

- Ensures that the MBT does not produce a significant revenue increase.
- If revenues exceed limit, one half refunded to taxpayers and one half deposited into the state rainy day fund.
  - FY 2008: if tax produces 5% or more than revenue neutral amount.
  - FYs 2009 and 2010: trigger increases by growth in personal income plus 1%.
  - Limit expires after 2010.

MBT Information

- Comprehensive MBT Web site, www.michigan.gov/mbt.
- Tax estimator will be on Web site.
- Education outreach (training seminars, webinars, roundtables, press releases).