MILLER CANFIELD

Governor Snyder's Budget Proposes Sweeping Changes to Business and Personal Taxes

February 22, 2011

Michigan Governor Rick Snyder released his 2011-2012 budget proposal on Thursday, February 17, calling for approximately $1.8B in business tax cuts, and changes to the Income Tax Act to increase revenue by roughly the same amount.

The business tax cut would be implemented by repealing the Michigan Business Tax (MBT) effective January 1, 2012, and replacing it with a 6% corporate income tax on "C" corporations. Certain credits granted as inducements for investments in the state would be honored, notably the advanced battery credits, but most other credits would be eliminated. When fully implemented in 2013, the proposal would eliminate roughly $2.1B in net revenue from the MBT, raise $800M from the corporate income tax, and allow $500M in credits for a net revenue after credits of $300M.

The Income Tax would be modified by eliminating the deduction for up to $90,000 of private pension income, eliminating the exemption of public pensions, reducing the homestead property tax credit available to seniors, lowering the income cap on the homestead property tax credit for all taxpayers, phasing out the $3700 personal exemption for higher incomes, freezing the tax rate at 4.25%, and eliminating the earned income credit and most other credits within the personal income tax act.

Corporate Income Tax

The corporate income tax would be based on federal taxable income. It would retain the nexus standards, apportionment formula, and unitary filing methodology of the MBT. The tax base would be very similar to the income tax base of the current MBT, but the modified gross receipts base of the MBT currently generates roughly 2/3 of the total revenue from the tax so eliminating this tax base represents a substantial tax cut. However, the most significant change is that "S" corporations, partnerships, LLCs, and proprietorships would no longer be taxable. The Governor estimated that 95,000 businesses would no longer be required to file a tax return under this proposal. A small business credit similar to the one currently provided under the MBT would also continue to be allowed.

The tax credit commitments that would be honored under the proposal equal $500M in FY13 and over $2.0B from FY12 through FY15. The largest component is the advanced battery credits at over $900M over the next four years, while the MEGA credit will grow from $111M in FY12 to $296M in FY15 and total over $750M over that same period. Other credits honored over that period would include $170M in brownfield credits, $100M in film credits, and $65M in various other credits. Some suggestion had been made that companies claiming these credits may remain subject to the former MBT, though these details were not discussed in the budget proposal.

The proposal calls for a cap of $25M per year on new film incentives, in contrast to approximately $125M in current film credits per year. No new MEGA credits would be granted, and instead economic development incentives would "be awarded through the appropriations process and reviewed for effectiveness."

Along with elimination of the MBT, the proposal also eliminates various broad-based credits based on wages and capital investment in the state which offset a portion of the tax. These credits equal over $500M today. The elimination of these credits reduces the benefit of the tax cut to in-state companies. Numerous other credits targeted to specific industries or specific taxpayers would also be eliminated. The theme is clearly broad base, low rate.

Personal Income Tax Changes

The largest component of the income tax changes is the elimination of the current deduction for private pensions equal to roughly $45,000 for single taxpayers and $90,000 for joint taxpayers. In addition public pensions, which are currently exempt, would become taxable. The revenue generated by the elimination of these exemptions has been estimated to be in excess of $700M.

The homestead property tax credit limit would be phased out from $61,000 to $70,000, reduced from the $73,650 to $83,650. The credit rate would be decreased from 100% to 80% to seniors and raised from 60% to 80% for all other taxpayers. The revenue effect from these changes was not disclosed.

The earned income tax credit would be eliminated, raising approximately $350M. The current credit is equal to 20% of the federal earned income tax credit.

The $3700 personal exemption would also be phased out for taxpayers with income above $75,000 for single filers and $150,000 for joint filers. Each exemption claimed equates to $157 in tax. No revenue estimate has been provided for this change.

The proposal also calls for elimination of numerous other credits in the income tax act including credits for farmland preservation ($39M), city income tax ($32M), public contributions ($25M), homeless shelter and food banks ($21M), and other miscellaneous credits ($11M).

Observations

There are various uncertainties to be clarified regarding the Governor's proposal, such as:

- Is it intended that taxpayers which continue to qualify for MEGA, battery, brownfield, or other credits must continue to pay tax under the MBT?
- How will the income from interests in passthrough entities such as partnerships and LLCs owned by “C” corporations be treated for apportionment purposes - will apportionment factors flow through?
- Will loss carryforwards from the income base of the MBT be allowed to carry forward to the new corporate tax?
- Will the legislation address the financial reporting implications of the conversion to the corporate tax which were addressed in the MBT by the so-called "FAS 109" adjustment to offset the deferred tax impact of the conversion from the SBT? The deferred tax impacts under the MBT should continue under the new tax, or be amplified if NOLs are not allowed to carry forward under the new tax.

Continued

The repeal of the MBT and replacement with an income tax only on Corporations also gives rise to a number of planning opportunities. For "S" corporations, partnerships, LLCs and proprietorships, there is a clear incentive to defer income and accelerate deductions, since any income recognized after 1/1/2012 would avoid tax. In addition, the acceleration of capital purchases to 2011 would generate a 100% deduction against the modified gross receipts tax as well as an investment tax credit. No ITC or accelerated deduction is proposed under the corporate income tax, so "C" corporations would benefit from this planning as well. Closely held "C" corporations may also want to analyze the potential to make a Subchapter "S" election or convert to an LLC to avoid the corporate tax.

The income tax proposals also present a number of interesting issues. For instance, will the legislature be willing to implement a corporate tax and pay for the business tax cut by raising the tax on individuals? If the legislature is unwilling to implement these changes, it may lead to the exploration of alternate, less costly business tax reform options. The current proposal provides significant relief to out of state companies since they pay a significant share of the tax due to the unitary requirement and broad nexus and apportionment standards, but benefit very little from the broad credits available to Michigan companies who have employees or make capital investments in the state. While it would add complexity, alternatives which target more tax relief on in-state job providers may be considered if the opposition to the proposed personal income tax changes proves too great to overcome.

The remaining aspects of the budget also are fraught with controversy, from reductions in local revenue sharing to cuts in the K-12 school aid formula and higher education, to state employee concessions. There are many hurdles to overcome before Governor Snyder's proposal becomes law. While the Governor has called for an all-or-nothing reaction from the legislature as opposed to a piecemeal approach by the legislature, it is possible that the package ultimately brought forward to the Governor by the legislature could look very different from the budget proposal presented last week.

For more information, contact a Miller Canfield State and Local Tax attorney or the author:

Gregory A. Nowak
313.496.7963