TAX RESTRUCTURING PROPOSAL

STATE OF MICHIGAN

Office of the State Budget

Tax Restructuring Proposal

Governor Granholm strongly believes that we are at a turning point – a decisive moment in Michigan's history. We must choose to invest in our people so Michigan can grow and compete. So we can build a Michigan where our children choose to raise their own families and where every citizen has the opportunity to have a good job and enjoy a good life.

The Governor believes this investment strategy will lead us to a better Michigan.

The two principal features of her investment proposal are the Michigan Business Tax, revised to reflect suggestions by the business community, and a two-cent tax on services other than education services and health care. With this proposal Michigan business taxes will remain below the national average and combined total state and local business and individual taxes will remain below the national average. Because of a sales tax break for new car trade-ins, most families that trade their car in for a new car in the next four years will see an overall tax cut under this proposal.

In the nineties, tax cuts were enacted on the premise that the good economic times would be long lasting. However, the economic picture in Michigan deteriorated rapidly after the tax cuts were enacted. In March of 2001, the U.S. economy went into recession and the U.S. economy did not start adding jobs again until the fall of 2003. In Michigan, the national recession and weak employment recovery coincided with a wrenching Big Three market share adjustment in which the their market share fell from 68 percent to 54 percent. Between 1999 and 2006, the drop in market share has resulted in a steep drop in manufacturing employment, with employment in this sector falling by 269,000 jobs.

The economic downturn combined with the tax cuts has had a profound negative effect on state revenues. General fund revenues for fiscal year 2007 and 2008 are forecast to be below the level they were at in fiscal year 1997. In fiscal year 2007, the state's income tax is expected to raise 12.5 percent less than it did in 2000, and the SBT is expected to raise 19.5 percent less. Michigan's revenues, which were at the Constitutional limit in fiscal year 1999, are projected to be $7 billion below the limit in the coming fiscal year.

Elements of the Plan:

The Governor's investment plan contains the following components:

- The Michigan Business Tax
- A two percent tax on services, excluding education and health care services
- A federally decoupled estate tax applicable to about 350 estates each year
- An increase in the tax on other tobacco products and a five cent increase in the rate on cigarettes
- An increase in the liquor mark-up percentage
- Elimination of certain tax loopholes
- A sales tax break for people based on the value of the car traded in for a new vehicle.

A Modified Michigan Business Tax:

Making Michigan's business climate more competitive continues to be a key component of Governor Granholm's comprehensive economic plan. The Governor believes it is time for a competitive, pro-growth business tax that is fair, simple and stable.

The Michigan Business Tax, as revised, continues to follow these principles:

- Create a business tax with the *broadest base* and the *lowest tax rate* possible
- Provide *substantial personal property tax relief* to industrial and commercial taxpayers
- Eliminate the tax on payroll, benefits and health care
- *Preserve economic development tools* to help attract new jobs and investment
- Spread the tax fairly to all types of business organizations while maximizing the number of businesses receiving a tax cut
- The MBT with revisions represents a $480 million tax cut from revenue neutral SBT
- Make the tax simpler.

Excise Tax on Services:

Michigan's sales tax is levied generally on the sale of tangible personal property, with a few exceptions. The use tax is levied on the use or consumption of tangible personal property and a handful of specific services. Tangible personal property that was subject to the sales tax is exempt from the use tax.

During the past 30 years, the structure of the economy has changed as services have become a larger part of overall economic activity. In 1975, service industries accounted for less than 33 percent of all national income and manufacturing accounted for 23 percent. In 2005, service industries accounted for 52 percent of national income, while manufacturing industries accounted for less than 13 percent. Employment has also changed. As recently as 1990, 25 percent of all Michigan employees worked in goods-producing industries, while 75 percent worked in service-providing industries. By 2005, 80 percent of all Michigan workers were employed in service-providing industries, with only 20 percent of Michigan workers remaining in goods-producing industries. As the economy has shifted from producing goods to providing services, Michigan's tax system has failed to shift and has remained dependent on taxing goods to provide much of the revenue necessary to support education, health, and public safety programs.

Because the current sales tax is levied almost exclusively on the consumption of goods, and not services, there is a disparity between the taxation of certain types of purchases. In addition, as economic activity has shifted from goods and toward services, the tax structure struggles to provide the revenue necessary to maintain government services as less and less overall economic activity is subject to tax. In 1978, 50 percent of retail sales were subject to tax; now only 39 percent are subject to tax.

The Governor's proposal levies an excise tax on most services at a 2 percent tax rate. The tax would be imposed on services consumed or used by consumers and businesses in Michigan. The low tax rate would apply to a broad base of service activity, reducing the economic impact of the new tax. Examples of activities subject to the new tax would include most entertainment activities, repair and maintenance services, construction services, legal and accounting services, landscaping and lawn care, and personal care services.

Governor Granholm believes that health care and education services should be exempt. The proposal would also exempt services purchased by the federal government, state and local governments, and school districts. Services purchased by non-profit organizations would generally be exempt if the service was related to the organization's main purpose. In addition, services that involve scientific research and development or computer systems design would not be subject to the tax. The tax would also not apply to admissions to zoos, museums, or historical sites.

The tax would be effective on June 1, 2007, and would raise approximately $477 million in fiscal year 2007 and $1.47 billion in fiscal year 2008. Most of the revenue would come from services consumed primarily by businesses, limiting the impact on individuals.

Here are some examples of how this might affect you:

- A $25 pedicure – tax 50 cents
- A $35 greens fee at golf course – tax 70 cents
- Theater tickets for $100 – tax $2
- $250 labor charge on vehicle repair – tax $5
- A monthly cable TV bill of $50 – tax $1
- $1,000 attorney fee for business client – tax $20
- $50,000 consulting fee – tax $1,000

Sales Tax on the Difference:

Most new vehicle purchases involve the sale of a used vehicle. Michigan is one of only a few states that allow no trade-in allowance on new vehicle purchases. For a buyer trading in a one-year-old vehicle, the value of the used vehicle may cover 2/3 of the cost of the new vehicle, and the buyer's out-of-pocket cost is only 1/3 of the new vehicle price. But Michigan requires buyers to pay sales tax on the full price of the new vehicle. In the example, the sales tax would equal 18 percent of the buyer's out-of-pocket cost. Allowing a trade-in allowance for new vehicle purchases will encourage new vehicle purchases in Michigan and bring another part of Michigan's tax structure in line with nearly all other states. The proposal saves taxpayers $180

Tobacco Products:

The current tax rate on other tobacco products (OTP) is 32 percent of the wholesale price – which is significantly lower than the current tax rate on cigarettes. The cigarette tax of $2 per pack averages between 80 and 150 percent of the wholesale price on a percentage basis, depending on whether the cigarettes are a premium or a discount brand. This significant tax differential has created an incentive for consumers to substitute tobacco products taxed as OTP for cigarettes. In addition, manufacturers have created new products that share many of the characteristics of cigarettes (white wrapping paper, filters, and packs of 20) but are sold as "little cigars." These products have a considerable price advantage due to the different tax rates assessed on OTP compared to cigarettes, and it appears these little cigars have experienced increased sales while cigarette sales have declined. The proposal doubles the tax on OTP and raises $36.6 million annually. The five cent increase on the cigarette tax will generate $21 million for 2008.

Liquor Markup:

The Michigan Liquor Control Commission (MLCC) is, by law, the wholesaler of all spirits in Michigan. Suppliers request approval from the Commission to have products available for sale in Michigan, distributed by the Commission.

The MLCC currently sells liquor with a 65 percent markup prior to selling to licensees. This markup represents approximately 20 percent of the retail price of liquor. Any profits from the sale of liquor are transferred to the state's general fund. The current proposal would raise the liquor markup to 75 percent. The increase in the markup rate would raise the retail price a small amount (less than 5 percent) and would increase the revenues to the School Aid Fund by approximately $29 million.

Decoupling from the Federal Estate Tax:

The Governor is once again proposing preserving Michigan's estate tax to retain state revenues that have been lost solely as a result of federal tax policy.

In 2001, the federal tax code was changed, providing a 10-year phase-out of the federal estate tax and, more importantly, repealing the state pickup tax by 2005. During this 5-year phase-out, the credit for state estate taxes was reduced by 25 percent each year starting in 2002 and completely eliminated in 2005.

At least 18 states and the District of Columbia have decoupled from the federal estate tax and made changes allowing their current estate tax levies to remain in effect. Governor Granholm's fiscal year 2008 budget proposes that Michigan join these states to insure the state's tax code is independent and no longer affected by federal changes.

The Governor is proposing that Michigan's estate tax law be based on the federal code that was in effect prior to the 2001 federal tax changes. Estates valued at $2 million or more are subject to the state's estate tax if the decedents death is after April 1, 2007; no taxes are levied for estates valued at less than $2 million. Assets attributable to family owned businesses, including farms, are excluded from taxation under this proposal. Michigan's estate tax law is expected to affect approximately 350 estates. Making this change effective April 1 will generate about $119 million in the coming fiscal year.

Eliminating Corporate Tax Loopholes:

Food Sold through Vending Machines
Food for immediate consumption is subject to sales tax and under current law, heated or chilled food sold through vending machines is subject to this tax. However, food products sold near room temperature, milk, and nonalcoholic beverages are not subject to the sales tax even yet these products are generally intended for immediate consumption. Taxing all food products sold through vending machines generates $27.2 million: $7.2 million in general fund revenue and $20 million in School Aid Fund revenue.

International and Certain Interstate Communications
Certain interstate telecommunication services are exempt from the use tax, including toll-free numbers, WATS services, interstate private networks, and international calls. It is not consistent to tax calls made within the state, or between states, but not tax calls made to other countries. A call to Sault Ste. Marie, Michigan is taxed; a call to Sault Ste. Marie, Ontario is not taxed. Requiring the use tax to be paid on telecommunication services that are placed or received in Michigan and billed to a Michigan service address or phone number generates fiscal year 2008 savings of $22.8 million: $15.2 million in general fund revenue and $7.6 million in School Aid Fund revenue.

Single Business Enterprise (Affiliate Nexus)
Some large businesses have organized their divisions into separate legal entities outside of Michigan to avoid Michigan taxes because they now have insufficient connection to the state. For example, a large chain of stores that has retail outlets in Michigan but also sells on its website could reorganize and form a separate internet business located completely in another state and channel sales into Michigan without collecting sales or use tax. Under this proposal, an out-of-state single business enterprise would be subject to tax if it shares a trademark or trade name with a related Michigan business; if the Michigan and out-of-state businesses pay for each other's services in whole, or in part; or if the Michigan and out-of-state businesses share a common or substantially coordinated business plan. Creating these standards for affiliate nexus to ensure collection of taxes generates fiscal year 2008 savings of $3.6 million: $2.4 million in general fund revenue and $1.2 million in School Aid Fund revenue.

Interstate Trucks and Trailers
The purchase or use of trucks, trailers, and parts is normally subject to the sales or use tax. However, the tax does not apply if as little as 10 percent of miles traveled occur outside of Michigan. That portion of the usage that occurs in Michigan would be subject to tax under this proposal. Taxing the Michigan share of usage generates fiscal year 2008 savings of $16.9 million: $11.3 million in general fund revenue and $5.6 million in School Aid Fund revenue.

Purchases made by Department of Corrections Inmates
Purchases made by inmates from prison stores located in Department of Corrections prison facilities are not subject to the sales tax. Requiring that sales tax be collected on all prison store purchases generates fiscal year 2008 savings of $700,000: $200,000 in general fund revenue and $500,000 in School Aid Fund revenue.

Tax Treatment for Commercial Rental Property
A 2002 Michigan Supreme Court decision (*WPW Acquisition v City of Troy*) barred complete implementation of 1994 Proposal A legislation regarding property taxation on commercial rental property. That legislation provided that in calculating the cap for determining the taxable value of commercial rental property, both increases and decreases in occupancy would be treated differently from market value changes affecting other types of property. The Michigan Supreme Court ruled that an increase in value due to an increase in a commercial rental property's occupancy could not be used to increase the property's taxable value beyond the constitutional assessment cap established by Proposal A. As a result of this court decision, commercial rental property taxes are based on occupancy decreases and are not adjusted upward if the property's occupancy rate increases. Removing commercial rental property from the General Property Tax Act and creating a new specific tax generates fiscal year 2008 savings of $5 million in School Aid Fund revenue.

Insurance Company Out-of-State Purchases
Under current law, insurance companies pay a tax under the Single Business Tax that is in lieu of all other taxes except taxes on real and personal property. This "in lieu of" provision exempts insurance companies from the use tax on items purchased from out-of-state retailers and from the sales tax when they sell property at retail. As a result, Michigan retailers are at a competitive disadvantage with out-of-state retailers and insurance companies are granted a competitive advantage when acting as a retailer. Eliminating the insurance companies' incentive to make purchases from out-of-state retailers generates fiscal year 2008 savings of $3.7 million: $2.5 million in general fund revenue and $1.2 million in School Aid Fund revenue.

Oil and Gas Income Double Deduction
Under current law, oil and gas activities in Michigan are taxed under the severance tax and, in return, the income from these activities is not subject to Michigan income tax. The Michigan income tax uses the federal adjusted gross income (AGI) as the starting point. AGI includes the net amount of business income after all business expenses have been subtracted. Since the income from oil and gas production is not subject to Michigan income tax, the net amount of oil and gas income should be subtracted from the AGI. However, Michigan courts have allowed oil and gas producers to take a different deduction from income. Certain indirect costs, such as depreciation expenses, are allowed a separate deduction from AGI, creating a double tax advantage for this group of taxpayers. Eliminating the double deduction generates fiscal year 2008 savings of $3.9 million: $2.9 million in general fund revenue and $1 million in School Aid Fund revenue.

Penalties for Certain Delinquent Taxpayers

In 2002, penalties were reduced for taxpayers that fail to file a tax return, or pay a tax on time, or pay a tax with a check that bounces. Almost half of the penalties are assessed on sales tax or income tax withholding which businesses collect from customers or take out of employees' paychecks and then fail to pay to the Department of Treasury. Restoring penalties for these late payments of certain income tax withholding, sales tax, and use tax, generates fiscal year 2008 savings of $5.1 million in general fund revenue.