

MACPA Member's Advisory Forum

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SBT Replacement Tax Discussion

Gregory A. Nowak



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Greg is the leader of the PricewaterhouseCoopers State and Local Tax Consulting practice in Michigan. Throughout his career, he has advised and represented many major companies on multistate tax matters including clients in the manufacturing, retail, and transportation industries.

Greg has substantial experience in both structural tax planning and state tax controversy matters. He is one of PwC's national state tax structuring specialists and has substantial experience in structural implementation. Prior to joining the firm, Greg worked as a tax attorney with a large Detroit law firm where he specialized in state and local tax consulting, litigating, and planning. He has litigated and negotiated issues involving all of Michigan's major taxes and has played an active advisory role in most of the significant Michigan tax controversies in recent years. He has substantial expertise with respect to the Michigan Single Business Tax.

Greg is currently on the board of the Michigan Association of Certified Public Accountants, and has served as the Chairman of the State and Local Tax Committee of the MACPA, as the Chairman of the State and Local Tax Committee and a member of the Tax Council of the State Bar of Michigan, and in many other leadership roles in these organizations. He is currently the Managing Editor of the American Bar Association Taxation Section publication "The State and Local Tax Lawyer". He has served as an adjunct professor of state and local taxation at Walsh College and as a Michigan correspondent for PricewaterhouseCoopers State Tax Notes. He is a frequent writer and speaker on matters of Michigan and multistate taxation.

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Single Business Tax Eliminated (Effective December 31, 2007)

Law change initiated by petition

Primary advocate: L. Brooks Patterson—Oakland County Executive

Legislature enacted the law

Impervious to gubernatorial veto

SBT is gone and with it \$1.9 billion of General Fund revenue (22%)

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Consensus Revenue Forecast, FY 2007

Tax	FY 2007 Estimate
Single business tax	\$1,885.9
Insurance tax	\$ 246.0
Total SBT	\$2,131.9
Tangible personal property taxes*	\$1,788.4

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SBT

136,000 total businesses

30% of business - 41,000 - pay no SBT

45% pay below \$1,000

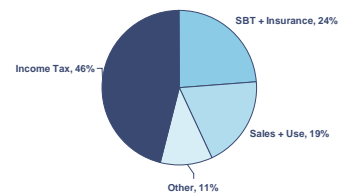
30% of current SBT liability paid by "out of state" business – with more sales in MI than property and payroll on a percentage basis

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SBT Provides One Quarter of GF-GP Revenue

May 06 Consensus Estimate Adjusted for Proposed Budget



FY 2007 GF-FP Revenues Total \$9.2 billion

Source: Robert Kleine, State Treasurer, Tax Reform for Michigan

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Michigan's Economic Condition –
How We Spend the General Fund FY2007

86% of General Fund spending in 4 areas

Higher Education (\$1.9B)—21%

Community Health-Mental Health, Public Health, Medicaid (\$2.9B)—32%

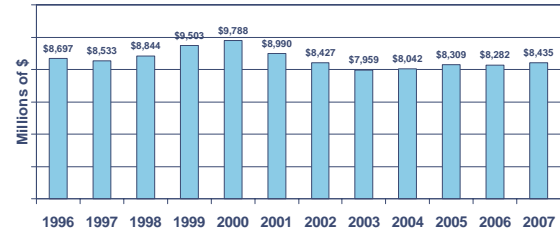
Corrections (\$1.8B)—20%

Human Services-family services, juvenile justice, cash assistance (\$1.2B)—13%

All other General Fund programs (\$1.3B)—14%

Source: Tom Clay, Director of State Affairs, Town Hall Meeting on Tax Reform

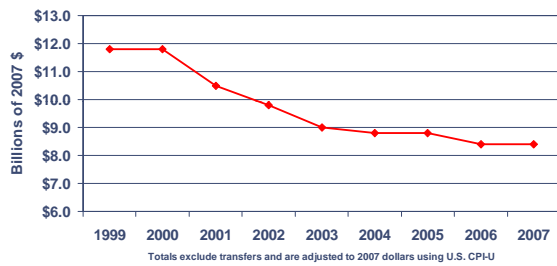
Nominal General Fund Net Revenue in 2007 Less Than in 1996



Note: Totals exclude transfers and savings from adjusting statutory revenue sharing payments to local governments.

Source: Robert Kleine, State Treasurer, Tax Reform for Michigan

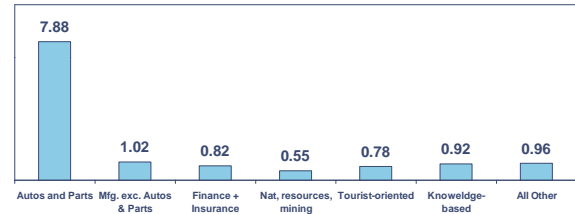
Inflation Adjusted GF-GP Revenue Down 28 Percent Since FY 1999



Source: Robert Kleine, State Treasurer, Tax Reform for Michigan

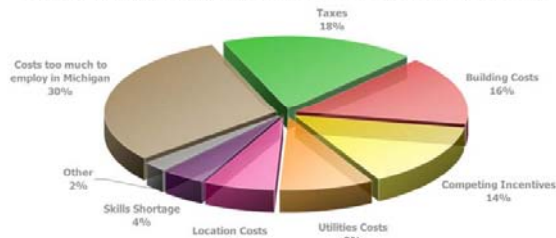
Drivers of Our Economy:
Dominant Effect of Auto Industry

Michigan Employment Compared to National Average



Source: George Fulton, University of Michigan, except finance + insurance calculated by Dept of Treasury

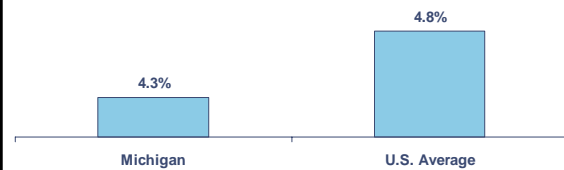
MEGA Grant Requests
Top Reasons Why Companies Said They Might Locate or Expand Elsewhere



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COST Study Puts Michigan Business Taxes Below National Average

FY 2005 State and Local Business Taxes as a Percent of Gross State Product



Source: Council on State Taxation, Bureau of Economic Analysis

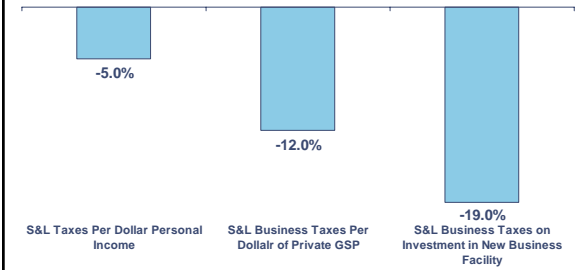
Michigan Business Burden Compared with Neighbors

State	Business Tax as % of GSP	Rank
Wyoming	9.6%	1
Illinois	5.3%	19
Minnesota	4.9%	23
Ohio	4.7%	27
Indiana	4.5%	30
Wisconsin	4.4%	33
Michigan	4.3%	46
DE, NC, VA	3.7%	48

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Upjohn Study Finds Michigan Taxes Below U.S. Average



Source: Robert Kleine, State Treasurer, Tax Reform for Michigan

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Problems with Current System

High personal property tax burden discourages investment in Michigan

SBT has been made more complicated through the years

SBT's bad reputation may be discouraging investment in Michigan

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Other Criteria for High Quality Business Tax System

Stable revenue source

Low compliance costs

Competitive tax rates with other states

Promote economic growth

Favor in-state business i.e. "export" the tax burden

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How to Encourage Businesses to Locate and Stay in Michigan

Provide several tools to promote economic stimulus

Avoid political favoritism, choosing winners and losers

Incentives should be available to everyone who engages in desired activity

Incentives should be easy to understand and utilize

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Alternative Business Taxes

Subtractive VAT (European cousin of the SBT)

Gross receipts

Licensing Fee (regressive?)

Franchise/net worth

Income (unitary or add back?)

Tax services (business-to-business, health care big pieces)

Other: Texas model, factor tax

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Replacement Tax Issues

Winners and losers

How much revenue should be replaced

Minimum tax? (30% of business pay nothing today, 45% pay less than \$1,000)

Ability to pay

Personal property tax relief (skew to mfg? Include telecom and utilities?)

Filing threshold

Capital and human investment incentives

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Options for Personal Property Tax Relief

Repeal completely (GR Chamber)

Tax credits – no local reimbursement issues (MI Chamber 50%)

Exemption from 24 school mills (6 state and 18 local school) delivers estimated 46% percent relief (Governor's plan)

Combine MI Chamber credit and milage reduction (House plan)

Exempt new property (Senate plan)

Differential credits based on new or existing

Mandatory PA 198 for all new property (50% reduction)

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National Perspective

More states debating significant changes in business tax systems to improve competitiveness:

- taxes on capital investment (business income, net worth, property, sales taxes on input purchases)
- Shift from profit-based to more stable revenue bases
- Shift from local (property tax) to destination taxes
- Major movement toward unitary tax systems (15 proposals)

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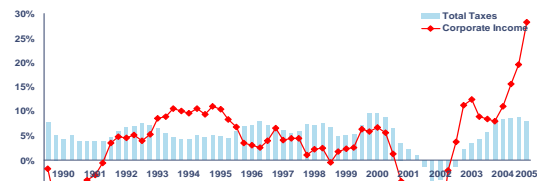
U.S. State-Local Business Taxes, FY05 (\$b)

Business Tax	Business Taxes	% Total Taxes
Property taxes on business property	\$182.8	37%
Sales taxes on business inputs	111.7	22%
Corporate income tax	42.1	8%
Gross receipts taxes (liabilities)	39.2	8%
Unemployment insurance taxes	35.5	7%
Excise taxes	24.5	5%
Business corporation license	20.9	5%
Other taxes	21.6	4%
Total S&L Taxes Paid by Business	\$478.4	96%
Business personal income taxes	19.1	4%
Total Business Taxes	\$497.4	100%

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S&L Corporate Income Taxes are Very Volatile



Year-over-year growth in corporate income and total taxes

Source: Robert Cline, State & Local Business Tax Reform

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Tax Policy Priorities in Other States

Adequate funding of government

Improving competitiveness

Changes in taxing multistate income

Nexus expansion or contraction (SSTP & BAT bill)

Shift to 100% sales factor (16 states)

Add backs disallow deductions

Expansion of combined reporting (15 states examining)

Avoiding P.L. 86-272 via non-income taxes

More stable revenue sources: minimum fees, net worth, gross receipts, and value-added taxes

Taxing all forms of business, both C-corps and pass-through entities

Increasing taxes on the service sector – to capture the revenue potential from this expanding sector

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New Style Business Taxes

Start with gross receipts

Gross receipts tax – few, if any, deductions

- General -- OH CAT, WA B&O, TX option, WVA local B&O
- Several industry specific – utility, insurance taxes, health care taxes

Value added tax – deduct purchases from other firms, including capital costs – when MI SBT is gone, only NH BET remains – Senate would bring it back

Gross margin tax – deduct cost of goods (COGS)

- Alternative minimum taxes -- NJ AMA, KY AMC
- General business tax -- TX (also allows compensation deduction as an alternative)

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Old School Business Taxes

Income tax – deduct purchases from other firms, compensation, interest expense, depreciation, other expenses

- Limited income tax – disallow select expenses (“bad” intangibles-related interest and expenses, “excess” compensation)
- Broad income tax – allow full deductions

Net worth of “franchise” tax

- 24 states have some form of franchise or net worth tax
- Provides revenue stability since not income dependent
- Sensitive to ability to pay

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Property Tax Trends in Other States

Business property tax cuts motivated the reforms in Ohio and Texas and are an increasingly important part of the MI debate

Several states have cut business property taxes: IN reduced school real property taxes by 60%; TPP repealed in OH, ME and CT; reduced in AZ, MI and MN, ID

State vs. local property tax relief

- CT and Ohio reimburse locals – (Governor’s plan)
- MI 15% manufacturing TPP credit against state taxes – (MI Chamber)

Other states have lots of property tax controversy: IL, NJ, KS (bus. TPP), NY

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Texas Reforms

Old tax: corporate franchise tax is the greater of 4.5% of net income or 0.25% of net worth – majority of business took advantage of partnership loophole and paid nothing

New tax: tax base is the lower of:

- 70% of revenues
- Revenues less cost of goods sold
- Revenues less compensation (including benefits)
- New rate is 1%; 0.5% for retailers and wholesalers
- Taxpayers include partnerships and LLCs
 - Mandatory combined reporting
 - Asserts that PL 86-272 does not apply
- Business tax and cigarette tax allowed school property taxes to be lowered by one-third

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Texas Reform Elements

Driven by state supreme court deadline and property tax pressures

Supported by local business community

Business entity tax increase of \$3.4b but total business taxes, including property tax cut, are slightly lower

Overall, a huge tax shift to close the loophole and export the tax burden by replacing property tax with franchise tax

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Ohio Reforms

Old tax: corporate franchise tax is the greater of 4 mills on net worth (max \$150,000) or 8.5% of income in excess of \$50,000

New tax: Commercial Activities Tax

- Tax base is gross receipts
- Tax rate is 0.26 percent when fully phased-in

Tangible personal property tax eliminated

Personal income tax relief

- Top bracket reduced from 7.5% to 5.95%
- Taxpayers with income under \$10,000 exempt

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Ohio's CAT – Why Did They Do It?

Claimed objective: grow the economy by improving business tax competitiveness

Eliminate the personal property tax

Reduce the tax burden on capital investments, increase taxes on consumption

Impose more uniform (and stable) taxes on all industries and forms of doing business

Reduce high personal income taxes (top combined marginal rates of almost 11%)

Deal with expiring 1% "temporary" sales tax increase -- \$1.5b problem

Ohio's CAT– Gross Receipts Taxes - Impacts

Even more prone to inequity than a sales tax since it taxes each step along the supply chain

Some argue it discourages in-state activities

Ended most incentives other than those targeted toward very large businesses

Businesses that are low margin and those that outsource are particularly hard hit

Some believe it has caused Ohio to lose to other state competition for jobs and growth

Major Controversies Regarding the Ohio CAT

Economic nexus – bright line test of \$500,000 in sales

Taxation of Services

Forced Combined Reporting – Nexus combined but full combination required to eliminate intercompany transactions

Taxation of Warehousing/Distribution Activity

Trading Activities

Financial Transactions

Expense reimbursements/agency issues

Quarterly reporting burdens

Taxability of food

Exemptions

Transition and Credits

Cross-industry equity issues

Michigan's Tax Reform Alternatives

Michigan Chamber of Commerce Proposal

Combination income and gross receipts

Inspired by Detroit Chamber of Commerce business license tax proposal

Business income tax rate 3.05%

"License tax" paid on gross receipts

- 0.48% general rate
- 0.24% on wholesale/retail
- Paid on excess above \$350k in gross receipts
- \$150 minimum tax on businesses with at least 1 employee
- \$2 million cap on license tax

50% personal property tax credit

Proposes \$500 million tax cut

Grand Rapids Chamber of Commerce Proposal

Tax on MI business activity

- MI sales or service revenues, less cost of tangible personal property purchased for resale, manufacturing, leasing or cost of funds for financial institutions (similar to Texas margin tax)

Also repeals personal property tax

Rate not to exceed 0.75% (some doubt this is realistic)

If tax exceeds estimates, credit in following year (e.g. Oregon)

Flat fee of at least \$150 for business with at least 1 employee

Proposes \$390 million tax cut

Fair Tax

- Expands sales tax to services and increases rate to 8.58%
- Replaces SBT, personal income tax, and personal property tax
- Economists say it won't work unless everyone has it.
- Estimates based on Gross State product may be overstated because exports are included.
- Likely requires a ballot proposal.

Governor's Sales Tax on Services Proposal

- Proposed 2% tax on broad range of services including business to business services
- Major Controversies:
 - taxing B to B
 - Exemptions pick winners and losers
- Senate voted against it and declared it dead
- Seems to be referenced by the Governor in the past tense

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Plan V

- 6% sales tax on services would replace SBT and lower personal income tax and personal property tax
- Supported by Auto Dealers and certain other groups
- various exemptions proposed especially for services consumed by individuals
- Would raise \$3.0B from business services, 1.3B from individual services

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Services are Half the Activity in the Economy Today

Potential Revenues from Taxing Services at 6%

- | | |
|------------------------|---------------|
| • Health care | \$2.9B |
| • B to B | \$3.6B |
| • Other services | <u>\$2.7B</u> |
| • Total | \$9.2 B |
| • Current Michigan SUT | \$8.5B |

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MACPA Whitepaper on Sales Taxes on Services

- State and Local Task Force developed an objective summary that addresses both the positive and negative issues surrounding sales taxes on services
- Distributed to Governor and members of legislature
- Provides guiding principles for an effective sales tax on service
- Not intended to support or propose any proposal, but merely to inform policymakers and other interested parties on technical issues, practical implementation challenges, and potential unintended consequences
- Whether enacted currently or not, these issues are not going away

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House Plan

- Governor agreed to support House plan in place of original factor tax proposal
- Proposal combines 6.95% unitary income tax and 0.488% net worth tax
- Provides 73% personal property tax relief to industrial property, 46% to commercial property
- Provides broadly available credits for jobs, investment, and R&D in Michigan
- Lower net worth tax rate applied to finance, real estate firms
- Revenue neutral

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Reactions to House Plan

- Governor agreed to endorse plan with reduced income tax rates (original draft had 9.4% rate, broader wage and PPT credits)
- Manufacturers fare well under the plan
- Michigan Chamber has given qualified endorsement
- Small business is seeking expanded relief
- Proposed amendments would extend wage credit to partnerships and LLCs
- Financial businesses, real estate sector, and service sector may see increases depending on level of credits received

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House Plan Small Businesses Relief

Businesses with gross receipts under \$350,000 would not be subject to the new tax. However, unlike the SBT, for small businesses with gross receipts between \$350,000 and \$700,000, the tax would be phased in at one-half the rates for other taxpayers, unlike the SBT where a taxpayer with one dollar over \$350,000 in receipts pays tax on all its business activity. Businesses with gross receipts of less than \$10 million and compensation to owners of less than \$115,000 would be able to pay the tax at the rate of 1.8 percent of adjusted business income.

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House Plan Property Tax Relief

Combines two elements:

- the Governor's proposed exemption for industrial and commercial property from the 6 mill state education tax and the 18 mill school operating tax imposed on non-homestead property.
- 50% credit for personal property taxes paid on industrial class property
- Districts would rely on the school aid formula to be reimbursed for the reduced local millage, and state funded credit would avoid impact on local units from other tax relief provided
- Local Government strongly supports this approach to PPT relief

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House Plan Credits

- Newly created credits
 - 0.8% wage credits for all existing MI wages
 - 3.3% investment tax credit for new investment
 - 4.0% R&D credit for MI R&D (not incremental)
- The House proposal also would retain the current MEGA compensation credit, Brownfield credits, historic preservation tax credits, MEGA credits for high tech jobs, credits for alternative energy technologies, and enact a new credits for research and development.

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House Plan Net Worth Tax

- GAAP net worth (assets less liabilities)
- Unitary net worth is somewhat unique concept
- Non-unitary and non-US net worth is eliminated
- distinguishing reserves from true liabilities
- Unaudited businesses may need assistance in presenting net worth in conformance with GAAP

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Senate Plan

- Proposes unitary income tax at 1.5% and subtractive value added tax (gross receipts less purchases from other firms) at 0.54%
- Exempts new personal property from tax beginning in 2008
- Provides 25% credit for commercial and industrial property purchased in past 5 years
- Financial institutions pay 0.225% net worth tax
- Provides for overall tax cut of \$600M

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Senate Value Added Tax

- Described as gross receipts tax without cascading effects
- In substance it is a subtractive value added tax (VAT) since it starts with gross receipts and allows deductions for purchases from other firms
- Like SBT, profit and labor are major components
- Like SBT, economists favor VAT taxes for economic neutrality
- Challenges:
 - Disconnect from Federal income tax
 - Michigan would remain only state in nation with VAT
 - Unclear what advantage it has over retaining current SBT

Senate Plan Credits

- Entrepreneurial credit for firms that add at least 20 jobs, have no more than \$25M in sales, and invest at least \$1.25M in MI ("Gazelle" credit)
- Headquarters jobs credit
- Preserves existing MEGA, Brownfield, Ren Zones incentives

Senate Plan Small Business Relief

- \$350,000 filing threshold
- Firms with receipts under \$15M can elect to pay lower of income tax or VAT tax

Common Elements of House and Senate Plans

- Unitary method
- Single sales factor
- Broad person definition borrowed from SBT
- Personal property tax reductions
- Retention of existing MEGA, Brownfield, Ren Zone incentives

Points of Distinction Between Plans

	House	Senate
PPT relief	x	
Low rates		x
Broad credits	x	
Exporting effects	x	
Number of losers		x
Tax cut		x

Issues with Unitary Taxation

- This dramatic change appears inevitable
- House and Senate plans have same basic effect
- Determination of unitary relationship is inherently subjective
- Treasury faces challenges in implementing a mandatory combined system
- May look at consistency with positions taken in other states
- Combining non-corporate entities under common control creates unique challenges in defining unitary relationships

Challenges faced by Treasury and Taxpayers

- Very little time left in year to implement new tax system
- Technical corrections need to be made to address issues under either plan
- New business registration under unitary model, drafting of interpretive guidance, development of forms will be substantial burdens on Treasury
- MACPA is committed to assisting our members and Treasury by lending our technical expertise through the State and Local Task Force and other interested members