Business Taxes

BACKGROUND

According to a 1995 study by the Institute on Taxation and Economic Policy (Washington D.C.), 41.8 percent of Michigan's state and local taxes are collected from business. This is very close to the national average of roughly 41 percent and ranks the state 34th highest among the 50 states. Michigan's major business levies are the following:

- single business tax (SBT)
- real and personal property taxes (state and local)
- sales tax (an estimated 25–30 percent is paid by business)
- unemployment insurance (UI) tax
- workers' disability compensation
- gasoline and vehicle-registration taxes

It is unlikely, however, that the final incidence of these taxes falls on business: A large share is passed on to consumers, employees, or shareholders, in the form of higher prices, lower salaries, or lower profit.

Since 1991 business taxes in Michigan have been reduced significantly. The Senate Fiscal Agency estimates that in 1997–98, tax savings to business will total $721 million, including $311 million in SBT tax relief. Given the numerous tax changes in recent years and slowdown in revenue growth, there are likely to be few significant SBT reductions in the next few years despite some continuing dissatisfaction with the tax; the most likely candidate for major reduction is the personal property tax on machinery and equipment.

The SBT, property, workers' disability compensation, and unemployment levies are discussed below. Gasoline, personal property, and sales and use taxation are discussed elsewhere in this book.

Single Business Tax

The SBT, easily Michigan's most important business tax, is a 2.3 percent levy on the value a business adds to its product during production, whether the product is automobiles or legal services. The main components of the added value are labor, interest paid, depreciation, and profit. An SBT deduction is allowed for capital investment, and special relief is provided for firms that are labor intensive or have gross receipts below a certain level; complete exemption is allowed for very small businesses.

GLOSSARY

Adjusted business income
Profits plus payments to officers and shareholders.

Base
In taxation, the dollar value on which the tax is levied, such as all nonexempt property or taxable personal income.

Capital acquisition deduction (CAD)
Single business tax deduction allowed for purchase of real and personal property.

Effective rate
Tax rate after credits, exemptions, and deductions are applied.

Final incidence
In the case of taxes, the person or entity who cannot shift all or part of the cost of the levy elsewhere.

Mill
A monetary unit equal to 1/1000 *of a dollar;* millage *is the tax rate on property—the number of mills assessed against the property's taxable value.*

Personal property
Generally, items not attached to real estate; e.g., equipment, computers, furniture, tools.

Real property
Generally, items permanently attached to real estate; e.g., land, buildings, fixtures.

Unemployment insurance (UI)
Provides money to workers to replace some of their lost wages after they have become unemployed.

Value added
The value a business adds to its product (or service) during production; the main components are labor, interest paid, depreciation, and profit.

Workers' disability compensation
System by which wages are replaced and medical/rehabilitation benefits are extended to men and women injured on the job.

The SBT took effect in 1976 as a replacement for seven business taxes, of which the largest three were the corporate income tax, the personal property tax on inventory, and the corporate franchise tax. Adopting the SBT marked a return to the value-added tax concept, which had prevailed from 1953 to 1967 in the form of Michigan's business activity tax. An experiment with the corporate income tax from 1967 to 1976 proved unsatisfactory because of the instability (severe cyclical fluctuations) of the tax and the complex administrative problems it posed.

The SBT has added stability to the Michigan tax structure and has exhibited reasonably good growth potential. As can be seen in Exhibit 1, collections rose from about $800 million in the first full year of collections (FY 1976–77) to a high of almost $2.5 billion in FY 1996–97 (including $208 million in insurance company premium taxes). This is an increase of 212 percent, which compares with a 275 percent increase in Michigan personal income during the same period. Without the numerous reductions in the tax base and the small reduction in the tax rate, the increase would have been much higher.

Exhibit 2 shows the distribution of SBT revenue by industry class for FY 1993–94 (latest data available). Manufacturing provides the largest part of SBT revenue, roughly 41 percent, but in the last decade its share has declined from about 55 percent. In comparison, from 1977 to 1994 the services sector's share rose from about 10 percent to 16 percent, and the finance/insurance/real-estate share rose from about 4 percent to 11 percent. The latter increase is due partly to extending the SBT to foreign insurance companies (organized out of state but doing business in Michigan) in 1987.

In theory, a value-added tax should extract a contribution from all firms, regardless of organization, size, or type of business. In practice, however, more than half the businesses in Michigan do not have an SBT liability largely because of an exemption for small firms and the deduction for capital investment; about 75 percent of the tax is paid by 5 percent of the firms. The SBT's actual *effective rate* (after credits, exemptions, and deductions are applied) is about 1.4 percent; it rises from 0.3 percent for the smallest firms to 1.73 percent for businesses with a $10–50 million tax base, and then falls to about 1.55 percent for businesses with a tax base exceeding $50 million. (These calculations are based on FY 1993–94 data and do not reflect subsequent revision to the SBT, but the changes probably have not substantially altered the tax's effective rate.)

EXHIBIT 1. Single Business Tax Collections, FY 1975–76 to FY 1996–97

Fiscal Year	*SBT Collections*	*Percentage of Total State Taxes*
1976	$354.9	8.8%
1977	803.5	16.9
1978	899.4	16.7
1979	1,001.3	16.7
1980	1,076.0	17.6
1981	942.2	15.2
1982	943.1	14.5
1983	999.7	13.9
1984	1,289.2	15.2
1985	1,372.7	15.4
1986	1,521.9	16.4
1987	1,497.6	15.6
1988	1,804.1	17.5
1989	1,845.4	17.0
1990	1,798.6	16.3
1991	1,573.7	13.4
1992	1,685.1	13.8
1993	1,791.1	13.9
1994	2,035.4	13.5
1995	2,130.4	12.2
1996	2,187.4	11.8
1997(est.)	2,224.2	NA

SOURCE: Senate Fiscal Agency.
NOTES: FY 1980 collections increased by $159 million due to the state's change from cash to accrual accounting. The FY 1987 decline is due largely to amnesty revenue collected in FY 1985–86. The large increase in FY 1988 is due partly to the tax's extension to out-of-state insurance companies.

Although over the years there have been many revisions to the SBT, several particularly important changes have occurred in recent years.

- The rate was modestly reduced, from 2.35 percent to 2.30 percent.

EXHIBIT 2. Distribution of Single Business Tax Collections, by Industry (quarterly payments only), FY 1993–94

Industry	*Tax Liability (thousands)*	*Percentage of Total*
Forestry, fishing, and agriculture	$5,872	0.3%
Mining	11,066	0.6
Construction	61,687	3.3
Manufacturing	768,781	40.9
Nondurable goods	179,529	9.5
Transportation equipment	259,367	13.8
Other durable goods	329,884	18.3
Transportation	36,532	1.9
Communication and utilities	133,610	7.1
Wholesale trade	84,471	4.5
Retail trade	251,344	13.4
Finance, insurance, and real estate	213,445	11.4
Services and other	313,275	16.7
TOTAL	$1,879,905	100.0%

SOURCE: Michigan Department of Treasury, The Michigan Single Business Tax, 1993–94, *July 1997.*
NOTE: 1993–94 data are the latest available.

- The alternate tax allowed for "small, low-profit" businesses (firms with less than $10 million in gross receipts) is 2 percent on adjusted business income (profits plus payments to officers and shareholders), down from 3 percent (originally 4 percent).
- There have been several revisions to the *capital acquisition deduction* (CAD) in recent years. One, to make the deduction more fair to firms doing business in Michigan but headquartered in other states, SBT payers are permitted to apportion their deduction using the same formula they use to apportion their tax base (see last bulleted item in this group.) This is a three-factor formula involving the portions of a firm's payroll, property, and sales that are located in Michigan: For tax years 1997 and 1998 the formula weights sales at 80 percent and property and payroll at 10 percent each. For tax years after 1998, the sales factor will increase to 90 and the payroll and property factors each fall to 5 percent. (Anticipating a legal challenge, legislators have consolidated all provisions pertaining to the CAD into a single section in the new law.)
- Business now are exempt from having to file an SBT return unless their maximum gross receipts exceed $250,000.
- Beginning in tax year 1995, workers' compensation, unemployment insurance, and Social Security payments were eliminated from the base of the tax. The inclusion of these components (as elements of value added) in the SBT base long had been a source of contention. These so-called taxes are very unpopular, and many businesses object to paying the SBT in addition; most economists, however, view them as legitimate components of the value added to a product during production. This major change has reduced SBT revenue by an estimated $117 million annually.
- The most recent and probably most far-reaching changes were enacted in 1995. For purposes of paying their SBT obligation, multistate firms always have been required to "apportion" their national economic activity to Michigan. For 1997 and 1998 a firm's apportionment formula now is calculated using 80 percent of its in-state sales, 10 percent of its Michigan payroll, and 10 percent of its Michigan property; for 1999 and beyond, the sales-payroll-property formula changes to 90-5-5. Firms that have more Michigan payroll and property than sales are expected to receive a SBT cut, and firms that have a greater physical presence outside the state are expected to receive a tax increase. To offset the state revenue reduction from the change in the apportionment formula, the CAD was substantially reduced for multi-state firms. If the 1995 SBT changes are ruled unconstitutional, the tax will revert to the old CAD calculation and the sales-payroll-property apportionment formula will return to 50-25-25 percent for the 1997 tax year, 60-20-20 percent for 1998, and 70-15-15 percent each year thereafter. To date, there have been no court challenges. The 1995 changes also expanded the tax credit for small businesses, beginning in 1998.

In 1991 the U.S. Supreme Court ruled in *Trinova Corp.* v. *Michigan Department of Treasury*, that the SBT does not violate the due process or commerce clauses of the U.S. Constitution. This ruling opens the door for other states to adopt value-added taxes, but to date none has.

Property Tax

State government and all local governments levy taxes on the value of real and personal property owned by commercial businesses; in addition, the state levies a tax on utility property, which equates to the statewide average property tax rate for commercial, industrial, and utility property (50.85 mills in 1996). All other business property, classified as commercial and industrial, is taxed at varying rates by local government units.

The school finance reform legislation of 1993 and 1994 changed the manner in which both residential and business property are taxed. Prior to the reforms, both residential and business property was taxed in the same way, but at varying rates, by local government units. Under the new system

- a 6-mill statewide education tax on all property is paid to the state School Aid Fund, and
- an 18-mill school operating levy on business property is paid to local school districts.

As a result of the reform, the average tax rate for all property in 1996 was 39.32 mills, down from the 56.64 mills in 1993, the last year under the old system. The average tax rate on business property was 50.85 mills; on nonbusiness property the average was 31.4 mills.

In 1996 business paid $3.3 billion in property taxes—roughly 43 percent of all property tax paid in the state. In 1993, business had paid about 28 percent of all property taxes.

All property, other than utility, is assessed by its local government and equalized by the county and the state. The assessment increase each year on each parcel of property is limited to the inflation rate or 5 percent, whichever is less. When the property is sold, the property is reassessed at current market value. Local governments thus must keep track of two values for each parcel: taxable value and assessed value. In 1997 assessments were limited to a 2.6 percent increase. The assessment cap is more beneficial to residential than business property, because the former generally increases more in value than does business property. From 1990 to 1994, commercial and industrial real and personal property values increased nearly 16 percent, while residential property value increased 32 percent.

Workers' Disability Compensation

Workers' compensation is a major business cost, although it is not a tax. The law requires that every employer subject to the federal Workers' Disability Compensation Act provide a way to assure that it can pay benefits to its workers injured on the job. Most companies buy insurance to protect them from workers' injury claims. With state permission, some employers who are financially sound are permitted to self-insure for this coverage, by paying into a regulated pool. In 1994 Michigan businesses paid upwards of $2 billion in workers' compensation payments—$388 per employee; the national per employee figure is $438.

The state's assigned-risk pool (an entity, managed by the state, from which hard-to-insure companies can purchase coverage) has asked for state approval to cut its rates, which means that all Michigan's workers' compensation rates for 1998 probably will decline for the third consecutive year. The rate drop results from the greater efforts companies are making to improve safety and to promote return to work by injured workers.

According to the Workers' Compensation Research Institute (Cambridge), Michigan's workers' compensation system is improving, as indicated by the following measures:

- From 1992 to 1996 the annual average total paid benefits per worker fell 4.6 percent (adjusted for inflation)

- From 1992 to 1996 the number of lost-time claims per 100 workers (the claim rate) fell from 2.5 to 1.8
- From 1991 to 1996 the interval from the time a dispute is filed to when a decision is handed down following a formal hearing fell from 18.1 to 13.6 months

There are many ways to compare workers' compensation state by state. In its November 1997 newsletter, the Workers' Compensation Center (Michigan State University) published 1995 state data showing that in Michigan, indemnity and medical UI benefits paid amounted to $1.41 per $100 of payroll; this benefit-cost rate compares with a national average of $1.51 and ranks Michigan roughly in the middle of the pack: 23d among the 50 states.

Unemployment Compensation Tax

Unemployment insurance is a form of social insurance, administered in Michigan by the Michigan Employment Security Agency (MESA). It is designed to provide money to help workers replace some of their lost wages after becoming unemployed. Unemployment insurance taxes are paid by almost all businesses that (1) employ one or more employees in any 20 given weeks in a calendar year or (2) paid $41,000 or more in payroll in a calendar year to employees covered by unemployment insurance.

Employers pay two "unemployment" taxes: federal and state. The Federal Unemployment Trust Account (FUTA) assesses an effective rate of 0.8 percent against the first $7,000 of each employee's wage. This money goes into the federal unemployment fund, which doesn't directly pay benefits to former workers but does assist the state with administrative and other costs associated with the program.

The state tax is levied on the first $9,500 of each covered employee's wages paid each calendar year, and the rate paid on that $9,500 is phased in over a business's first five years in operation. The taxes are deposited in the state Unemployment Insurance Trust Fund, which makes payments to workers who have become unemployed. Each employer has an "account"—that is, a record is kept on how much the firm has paid in and how much the trust fund has paid out in benefits to the firm's former workers.

- Generally, in the first two years of a business's liability, the tax rate is set by law at 2.7 percent (except in the construction industry, where the first two years' rate equals that of the average employer in the construction industry; in recent years this has been 7–8 percent).
- In the third and fourth years, liability is based partly on the how much in benefits has been paid out in the firm's behalf and partly on the size of the firm's taxable payroll. In the third year, only one-third of the amount of any unemployment claims are used to determine the tax rate, and a uniform 1.8 percent rate is assessed on that amount; firms with no layoffs (and thus no unemployment claims made against them) in the prior two years may have a rate as low as 1.8 percent, while others (which have unemployment claims against them) may have a rate as high as 3.8 percent.
- In the fourth year, two-thirds of the amount of any unemployment benefit changes are used to determine the tax rate, and a uniform one percent is added to the resulting computation. Firms with no layoffs pay one percent, and those that have substantial layoffs—and thus a substantial amount of money paid out in benefits—may pay up to 5 percent.
- In the fifth and subsequent years, the full amount of any unemployment benefits charges are used to determine the tax rate. The amount of tax assessed against a business also depends on whether the firm has built up any reserve in its MESA account. For 1997 tax rates may range from 0.3 percent (for businesses that have had no layoffs in the last seven years and an adequate reserve in their MESA account) to 10 percent (for firms with high layoffs and little or no reserve). The effective tax rate for all firms in 1996 was 3.6 percent.

Public Act 25 of 1995 made several important changes in unemployment taxes. First, the minimum tax rate was reduced to 0.5 percent (without the bill, the minimum would have increased to one percent in 1999). Second, whenever the trust fund reaches a level equal to 1.2 percent of the aggregate payrolls of all contributing employers, employers' tax *rates* are cut—at least 0.1 percent, which may amount to as much as a 10 percent drop in the *amount* they pay. Third, the law increases the extent to which claims experience is counted, by providing that employers who have had no charges made against them for more than five years will have their tax rate reduced. This legislation resulted in unemployment taxes being reduced in 1996 and 1997. The 1997 average tax cost is expected to be about $38 per employee—totaling $125 million statewide. The balance in the UI Trust Fund must be substantial as a cushion against recession; it was $2.1 billion as of June 30, 1997.

DISCUSSION

Single Business Tax

The SBT generates controversy mainly for two reasons: It (1) substantially increased the tax burden of many businesses that had been paying little or no tax, and (2) requires a tax payment even when no profit is earned. During debate on the 1988 legislation, which provides the alternative tax for small (and, some say, medium-size) firms, supporters of the alternative argued that the SBT was hurting small firms and that business should not pay a tax unless a profit is earned. Opponents argued that because all firms use government services, all should make a contribution (as with the local property tax) regardless of whether a profit is reported, that a two-tier tax structure is unfair, that moving to a profits tax would make the SBT more unstable, and that the tax burden on most small businesses is too minor to have a negative effect on them.

From a tax policy perspective, a major concern is that the numerous special provisions added to the tax have made it too complicated. Also, the major reasons for enacting the tax—stability and equity—are being compromised by the continuing expansion of the profit alternative. A case can be made that the tax should be simplified and returned to its original purpose by eliminating most special provisions and lowering the rate. The original purposes of the SBT were to (1) simplify the tax system, (2) increase its stability, (3) provide a more neutral tax treatment for businesses, and (4) improve the investment climate. In large part these goals have been achieved, but many believe they are being compromised.

Property Tax

Prior to passage of school finance reform and the reduction in property tax rates, Michigan's property tax burden was about one-third above the national average and 50 percent above the burden in Ohio and Indiana, which caused many to view the tax as detrimental to economic development, particularly in southeast Michigan, where tax rates are higher than in most other regions of the state. Since the reforms, Michigan is at about the national average, although the tax on business still is modestly above. While property tax is of less concern since the reforms, the business community still views the personal property tax on machinery and equipment as a large negative for the business climate.

Workers' Disability Compensation Tax

Despite recent cost declines, the business community still believes legislation is needed to reduce fraudulent and unwarranted claims. In a Michigan Manufacturers Association membership survey (January 1997), workers' compensation costs ranked among the three items that most concern manufacturers. With the Democrats controlling the House, it is unlikely there will be any major changes to the system in 1998.

Unemployment Compensation Tax

Unemployment insurance costs long have been viewed as a burden to business and a deterrent to economic development. In FY 1993–94 , UI taxes paid by Michigan businesses amounted to $168 per capita, 46 percent above the U.S. average of $115. These higher taxes pay for higher benefits: In 1994 the average weekly benefit paid in Michigan was $213 per capita, 17 percent above the national average and the highest in the Great Lakes region. (In 1995 the average weekly benefit was $221, 18.2 percent above the national average.) The 10 percent tax cuts in 1996 and 1997 and expected future tax cuts will bring Michigan more in line with other states and reduce the negative effect that UI taxes have on the state's business climate.

See also Economic Development: State Financial Incentives; Headlee Amendment; Job Training; K–12 Funding; Personal Property Tax; Road Funding; Sales and Use Taxes; Urban Revitalization.

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