

Review of Governor Granholm’s 2007 Tax Restructuring Plan

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Prepared in Partnership with the Michigan Chamber of Commerce

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SUMMARY

The Granholm administration’s 2007 tax plan has several positive features, which we summarize in Table 1. However, the Governor’s plan misses the mark with its assets tax and its “excise tax on services.” These taxes are poorly designed, taxing business input purchases and investments in the state. If the Governor’s tax plan were to be adopted, Michigan would again have a tax system that is not in step with the rest of the country. For example, a typical Michigan business would pay six different business taxes, while businesses in competing states like Ohio would pay only two. Many of the negative features of the Governor’s plan could be remedied if the “excise tax” on business-to-business service purchases and the asset tax were eliminated from her plan.

TABLE 1. Evaluation of Governor Granholm’s Tax Plan

Positive Features	Negative Features
<ul style="list-style-type: none"> * Relies primarily on taxes with low rates on broad tax bases to raise revenue. * Provides personal property tax (PPT) relief for commercial and industrial property. * Provides tax relief for small businesses. * Offers overdue tax relief on new car purchases. * Could provide tax advantages to businesses headquartered in Michigan. 	<ul style="list-style-type: none"> * Taxation of business-to-business sales creates economic distortions and raises the cost of doing business. * Advertised as a “tax on business” but individuals bear the burden of this tax because individuals pay all taxes. * Taxes professional business services at a high tax rate. * “Asset Tax” deters new investment in the state. * Constitutional problems due to HQ exemptions, apportionment if no Michigan sales; and treatment of “excise tax” as distinct from a sales tax. * Unclear how services will be taxed when only one party in the transaction of a service is in Michigan. * PPT relief not extended to utilities. * Taxes businesses with more unique taxes than other states.

Source: Anderson Economic Group, LLC

INTRODUCTION

On August 9, 2006 the Michigan House and Senate approved the initiated petition that repealed the Single Business Tax (SBT). This action by the Legislature was the culmination of an eight month effort initiated by Oakland County Executive Brooks Patterson to force the repeal of the SBT earlier than its planned expiration. Many citizens signed the initiated law—291,741 signatures were certified through the Michigan Secretary of State’s office—affirming the need for “a tax that is less burdensome and less costly to employers, more equitable, and more conducive to job creation and investment.”¹ The SBT is repealed after December 31, 2007.

The SBT generates almost \$2 billion annually in state revenue. Since its repeal, the debate has shifted from *whether* it should be repealed to *how much* tax revenue should be replaced and what *form* the replacement tax should take. Recent studies have pointed out that Michigan’s taxes on business are at best average, with certain business taxes well above average, and that the current system of business taxation is poorly designed.²

Several replacement taxes have been introduced as bills in the state legislature. These include the Senate Republicans’ “Business and Economic Stimulus Tax” (BEST) plan, the Michigan Chamber of Commerce’s plan, and Governor Jennifer Granholm’s “Tax Restructuring Plan.” This document contains our preliminary analysis of Governor Granholm’s tax plan. We reviewed the Governor’s original Michigan Business Tax (MBT) proposal released in November of 2006, her “Tax Restructuring Proposal” that was part of her Fiscal Year 2008 Executive Budget, and the bills released in the Michigan House and Senate in early March.

GOVERNOR’S 2007 TAX PLAN

Democratic legislators introduced Governor Granholm’s tax plan in bill form on March 1, 2007. The main components of her plan include a Michigan Business Tax (MBT) levied on most business activity, an “excise tax” on most services, personal property tax relief, an increase in some existing taxes, and tax relief for new car purchases that involve a trade-in. We discuss these components in more detail below, and reference the House Bill numbers, although identical Senate Bills exist.

1. Michigan Business Tax (HB 4367)

The MBT would replace all of the \$1.9 billion generated by the main tax on business activity, the Single Business Tax. The main components of the MBT include:

1. *A tax on gross receipts at 0.125%*

Gross receipts are the total receipts of a business for sales of goods or services during the tax year. Taxable gross receipts would be apportioned to Michigan based on the business’s sales in Michigan.

1. Language taken from initiated law, Public Act 325 of 2006.

2. See Patrick L. Anderson and Caroline M. Sallee, *Benchmarking for Success: A Comparison of State Business Taxes* (2006), available at: www.AndersonEconomicGroup.com. See also Curtis S. Dubay and Scott A. Hodge, *State Business Tax Climate*, Tax Foundation (2006).

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2. *A tax on assets at 0.125%*
Assets are defined as: cash, trade notes, accounts receivables, mortgage, real estate loans, buildings, depletable assets, land, intangible assets, “other investments” and “other assets.” Assets would be apportioned to Michigan based on sales.
 3. *A tax on business income at 1.875%*
Business income is the profit a business receives from its business activity. The business income tax base would be apportioned based on the business’s Michigan sales.
 4. *Tax Relief for Small Businesses*
Under Granholm’s proposal, small businesses with annual gross receipts under \$350,000 would not have to pay the MBT. The MBT also phases in tax liability for small businesses with gross receipts between \$350,000 and \$700,000.
 5. *Retention of Credits for Certain Activities*
The MBT retains the current MEGA compensation credit, which provides a credit equal to up to 100% of compensation for created or retained jobs for up to 20 years. The MBT also creates a new MEGA credit for established Michigan business to help fund R&D. It also honors commitments made before the end of 2007 for the brown-field and historic preservation tax credits. Business activity occurring in Renaissance Zones will continue to receive tax exemptions.
 6. *Increased Taxes for Insurers*
Insurers would have to pay a tax of 1.25% on their gross receipts, and current credits would be eliminated. This will most likely result in a tax increase for insurers.

2. “Excise Tax on Certain Services” (HB 4368)

In HB 4368, Governor Granholm proposes an “excise tax on certain services” at 2% that would take effect June 1, 2007. While labeled an “excise tax” this tax has certain features of a gross receipts tax, but generally functions like a sales tax. HB 4368 includes an extensive list of what services would be taxed, but also states that the services listed in the bill are “illustrative” and not exclusive. Examples of services to be taxed include:

1. Finance, Insurance and Real Estate
(insurance services, investment counseling, real estate sales and management fees)
2. Personal Services
(hair cuts, pet grooming, health clubs, dry cleaning, shoe repair, tax return prep)
3. Business Services
(advertising, janitorial, marketing, lobbying, consulting, telemarketing, secretarial)
4. Amusements
(park admissions, bowling alleys, video games, professional sports events, fairs)
5. Professional Services
(accounting, architecture, legal, engineering, land surveying, veterinary services)
6. Repair and Fabrication
(labor charges on repairs to tangible property, installation charges)

Exempt Services. Services that would be exempt from the tax include health care services (physicians, dentists, hospitals, nursing care facilities, community care facilities), social assistance services, educational services, telecommunications, air transportation, admissions to museums, historical sites, parks, and zoos, gambling industry services, publishing and broadcasting, internet service providers, rail and truck transport, computer systems design (includes writing and testing software), and scientific research and development. The House and Senate bills include some exemptions for financial institutions.

Exempt Purchasers. In addition, certain purchasers would be exempt from this tax. These include farmers (when purchases are for farming operations), manufacturers (for direct use in manufacturing), governmental entities, nonprofit organizations, extractors (for direct use in extractive operation), and regularly organized churches or houses of worship.

Additional Relevant Provisions of the Tax. The “excise tax on services” would be levied on firms performing or delivering a service in which the service is *purchased* in Michigan. When charging the tax for the service, the taxpayer must show the tax separately on any invoice or similar document given to the purchaser.³

3. Personal Property Tax Relief (HB 4369 - HB 4372)

The Governor’s plan exempts “qualified personal property” from the 18 mills levied for school-operating purposes and the 6 mill state education tax. “Qualified personal property” includes commercial and industrial property, as defined under the General Property Tax Act, but does not include utilities and other taxpayers.

4. Increases Existing Taxes (HB 4377, HB 4389, SB 339)

The Governor’s tax plan re-instates taxes on estates worth over \$2 million (HB 4377), raises taxes on cigarettes and tobacco (HB 4389), and increases the liquor markup from a maximum of 65% to a maximum of 75% (SB 339). The Governor’s plan would raise taxes on cigarettes by 0.25 mills per cigarette and increase taxes by 64% of the wholesale price for cigars, non-cigarette smoking tobacco, and smokeless tobacco. The increase in taxation of tobacco would take effect June 1, 2007.

5. Tax Relief on New Car Purchases (HB 4373)

The Governor’s tax proposal would allow a trade-in credit when calculating the sale price for the sales tax on a new vehicle purchase. A buyer of a new vehicle that is trading in a used vehicle would pay sales tax on the difference in the value of the two cars.

3. See Sec. 5(1) and Sec. 21(2) of HB 4368.

**DISCUSSION OF
GOVERNOR'S 2007
TAX PLAN**

Positive Features of the Governor's Proposal

The Governor's 2007 "Tax Restructuring Plan" has several good features. It provides personal property tax (PPT) relief for commercial and industrial taxpayers, although it does not provide similar relief for utilities. PPT relief is important to major employers in the state, particularly manufacturers, that have large amounts of personal property. PPT relief will make Michigan more competitive regionally as several nearby states—Ohio, Pennsylvania, and Illinois—do not levy personal property taxes.

Other positive features of the Governor's tax plan include the MBT's form, the MBT's taxation of small business, and allowance for trade-in vehicles when computing sales tax. The MBT's combination of gross receipts and business income taxes, levied on broad tax bases at low rates, minimize economic distortions. The Governor's plan phases in taxation of small businesses with gross receipts between \$350,000 and \$700,000, and businesses with gross receipts of less than \$350,000 are not subject to taxation. The credit for a trade-in vehicle when calculating the sale price of a new vehicle is needed for equity, and provides tax relief for purchasers of new cars.⁴

While Governor Granholm's tax plan has some good features, the bad outweighs the good. This is primarily due to: the taxation of assets, the taxation of business-to-business transactions, the high tax rate imposed on professional business services, and a reduction in transparency in the tax system.

Problem 1: "Asset Tax" Deters New Investment in the State

Governor Granholm's MBT includes a new tax on assets. Taxable assets, as mentioned previously in "Governor's 2007 Tax Plan" on page 2, include cash, accounts receivable, land, buildings, and "other investments." This tax has several problems.

First, it repeats one of the problems that Michigan has with the SBT: it is unique. Businesses would have to learn a new tax that is not levied in other states, resulting in significant compliance costs for businesses. Compliance costs are not limited to only businesses. The government would need to set rules and define precisely what assets are subject to taxation, and how the tax should be processed. For example, it is unclear what exactly "other assets" and "other investments" the Granholm administration means when identifying these as taxable assets.

Second, again similar to the SBT, an assets tax discourages investment in Michigan. It sends a message to new and existing businesses that they do not want to hold property or other assets in the state because it will be taxed multiple times. Some of the businesses that will be hurt by this tax include companies with high fixed assets, cash on their balance sheets, or accounts receivable.

4. Currently, a purchased car is taxed on the entire sale price, while a leased car is taxed only on the portion of the "tangible personal property" actually used.

Problem 2: Taxation of Business to Business Transactions

A significant problem with the Governor's tax plan is that two of the taxes—the gross receipts and “excise tax on services”—tax business-to-business sales. Rather than applying a tax at the final sale to the consumer, like a retail sales tax, these two taxes apply a tax on a good or service at each stage of the production process, resulting in the *pyramiding* of the tax.

For example, the “excise tax on services” would affect a golf course owner. If a Michigan golf course owner hires a lawn-care service to maintain the golf course, under the proposed “excise tax on services” the lawn-care company would need to collect 2% of the sale price of the service from the golf course owner and remit it to the state government. The golf course owner would then charge the 2% “excise tax” when he or she sells use of the course to a golfer. Both the input (lawn-care) and the output (greens fee) would be taxed under this proposal. This is a problem because the taxation of business-to-business transactions creates certain economic distortions, which we list below.

- These taxes encourage businesses to vertically integrate to avoid taxable transactions. Thus, these taxes favor large companies that complete the entire production process in-house over small to medium sized firms that are part of an independent production process.⁵
- These taxes are levied on business inputs, increasing the cost of doing business and placing the state's producers at a competitive disadvantage in markets outside the state.
- These taxes put upward pressure on the final price of consumer goods. Businesses will bear some of the tax burden, but if a business is able to pass along some of the tax burden to consumers, in the form of higher prices, it will do so.

Problem 3: High Tax Rate on Professional Business Services

Michigan would have one of the highest tax rates in the country on professional services if the “excise tax on services” were adopted. While many states tax some services, such as greens fees or haircuts, *most states do not tax professional services* that are purchased by other businesses. According to the Granholm administration's own analysis, only six states tax services such as accounting, architecture, legal, engineering, and veterinary,⁶ while the CCH reports that only four states—Connecticut, Hawaii, New Mexico, and South Dakota—generally tax professional services.⁷ Even Hawaii, which taxes almost all services at 4%, taxes *intermediary* (i.e. business-to-business) sales of services at 0.5%. The Governor's “excise tax on ser-

5. For more information on the effects of pyramiding taxes see Robert Cline, John Mikesell, Tom Neubig, and Andrew Phillips, *Sales Taxation of Business Inputs*, Council on State Taxation (January 2005); and John Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, Tax Foundation (January 2007).

6. See Department of Treasury, “Taxation of Services under the Two-Penny Plan,” released February 2007.

vices” will make Michigan’s professional services uncompetitive, especially in industries with low profit margins.

Problem 4: Reduces Transparency in the Tax System

The Granholm Administration estimates that the “excise tax on services” would raise \$1.47 billion in FY 2008, and that “most of the revenue would come from services consumed primarily by businesses, limiting the impact on individuals.”⁸ When taxes are imposed during the production chain, as they are in the proposed “excise tax” that taxes business-to-business sales, firms incorporate these costs and, to the extent they can, pass them on to consumers at a later stage. The idea that if “businesses” pay taxes, then individuals escape the burden, is incorrect. Ultimately it is *people* who pay taxes—consumers, workers, and investors—that work for or interact with businesses.⁹ Business taxes simply make the tax burden that individuals ultimately must bear less transparent.

Problem 5: Tax Raises Administration & Constitutional Questions

Treatment of Services. Section 5 (1) states that the “excise tax on services” will be levied and collected from businesses performing a service in which the purchaser is in Michigan. While this section makes it clear that services performed and received in Michigan are subject to the “excise tax,” it is unclear how services either performed out-of-state and purchased by someone in Michigan, or services performed in Michigan and purchased by someone out-of-state, will be treated. The sourcing language in the bill does not clarify these issues.

Constitutional Issues. The Governor has proposed her “excise tax on services” as a distinct tax, rather than as an extension of the General Sales Tax (Act 167 of 1933). Since the tax is on services, and not tangible personal property, it appears that the “excise tax on services” would *not* be subject to the 6% limit in the Michigan Constitution.¹⁰ Additionally, if the “excise tax on services” is considered a sales tax, then it would violate some provisions of the streamlined sales and use tax agreement, which Michigan has signed and implemented. For example, the addition of a separate rate for services violates the provisions in this agreement.¹¹

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7. According to the *CCH 2006 State Tax Handbook*, these states levy several taxes on business. All levy a corporate organization fee. Connecticut has a corporate business tax, a personal income tax, and select excise taxes. Hawaii levies a general income tax, and a general excise (gross income) tax. New Mexico has a franchise tax, an income tax, and a gross receipts tax. South Dakota has many severance and specific excise taxes.
 8. See page B-3 of the Governor’s “Tax Restructuring Proposal” in FY 2008 Executive Budget.
 9. For a discussion of some of these issues see Michael L. Marlow, *A Primer on the Corporate Income Tax: Incidence, Efficiency and Equity Issues*, Tax Foundation (Nov. 2001).
 10. Article 8 of the Michigan Constitution limits the sales tax on gross taxable sales of tangible personal property to 4% and 2%.

A second constitutional issue pertains to the “headquarters credit” that appears in Section 38 of the MBT bill. A taxpayer that maintains a “headquarters facility” in Michigan would be allowed to claim a credit against the MBT. A tax law that clearly discriminates against out-of-state firms is likely to be found unconstitutional, under the U.S. Constitution’s Commerce Clause. Thus, Michigan businesses should not rely upon this or other tax provisions that treat in-state firms differently than out-of-state firms with similar business activity.

COMPARISON OF GOVERNOR’S PLAN WITH OTHER TAX PLANS

The three replacement taxes that have been introduced as bills in the Michigan Legislature have certain similar features. All three plans tax businesses with a combination of gross receipts and business income taxes. These taxes are levied at low rates on broad tax bases. All plans also offer some personal property tax relief. See Table 2 below.

A major difference between these plans is the asset tax and “excise tax on services” in the Governor’s plan and the absence of these taxes in the other two plans. The result is that the other two plans offer a tax cut between approximately \$400 and \$500 million, while the Governor’s plan will likely increase taxes on businesses.¹²

TABLE 2. Comparison of Key Elements of Major Tax Plans

Tax	Granholt Tax Plan (HB 4367-4377, HB 4389)	Michigan Chamber (SB 151)	Senate BEST Plan^a (SB 94-96)
“Excise Tax on Services”	2%	0%	0%
Gross Receipts	0.125%	0.48%-general 0.24%-retailers/wholesalers	No rate listed in bill
Business Income	1.875%	3.05%	1.97%
Asset Tax	0.125%	0%	0%
Personal Property Tax Relief	Commercial & industrial property exempt from 24 mills	50% refundable tax credit for all job providers	New industrial property will not be taxed; 10% credit for property acquired last 5 years
Treatment of Small Business	No MBT for businesses w/ GR under \$350K; phases in taxes for bus. w/ GR \$350K-\$700K	Tax of \$150 for businesses w/ GR under \$350K & 1 employee	No business income tax if GR less than \$350K; \$100 tax for GR \$100K-\$350K
Impact on Business	Probable Tax Increase	\$500 M Tax Cut	\$390 M Tax Cut

Sources: House Bills 4367-4377, 4389; Senate Bills 94-96,151.

a. According to articles in *MIRS* on February 8, 2007 and March 1, 2007, the Senate Republicans intend to modify the BEST Plan so that the gross receipts tax rate will be less than 0.7%, the business income tax rate will be 1.5%, personal property tax relief would include commercial property, and the credit would increase to 20%, and no flat \$100 tax. The Senate Republicans have not released bills for these proposed changes to the BEST plan.

11. See CCH, “State Delegates Approve Historic Sales and Use Agreement; Major Impact Anticipated,” (Jan. 2003).

12. The estimates of tax increases or decreases for each of the plans compared to the SBT are based on information from the supporters of the plans. They are not AEG estimates.

COMPARISON OF GOVERNOR'S PLAN WITH OTHER STATES

Currently, two states primarily tax businesses with gross receipts taxes: Washington and Ohio. Washington levies the Business & Occupations (B&O) Tax, while Ohio recently adopted its own gross receipts tax, the Commercial Activities Tax (CAT). In Table 3 on page 9, we present a comparison of the tax structures of these two states and compare it with the tax structure Michigan would have if the Michigan Legislature adopted the Granholm tax plan.

The first notable difference between the tax structures in these states is that Michigan would have several more taxes for businesses than the other two states. In addition to a gross receipts tax, Michigan businesses would need to calculate and file *two more* taxes on business income and assets, as well as filing personal property taxes. Ohio is phasing out its taxes on personal property while Washington does not have an individual income tax. Many more businesses in Michigan would be affected by the “excise tax on services,” than in the other two states. Ohio and Washington tax far fewer services than the Granholm proposal intends to tax, and both states do not tax most professional business services. See Table 3 below.

TABLE 3. Comparison of Taxes on Businesses in States with Gross Receipts Taxes

Tax	Michigan (w/ Granholm Plan)	Ohio	Washington
General Excise or Sales Tax on Services	2%	No	No
Excise or Sales Tax on Select Services	Yes (e.g. utilities)	Yes (e.g. amusements)	Yes (e.g. personal, construction)
Sales Tax on Tangible Property	6.0%	5.5%	6.5%
Gross Receipts	0.125%	0.26%	0.138% - 1.63%
Business Income	1.875%	No	No
Asset Tax	0.125%	No	No
Personal Property	Yes	No	Yes
Individual Income (on pass-through bus. income)	3.9%	0.712% - 7.185%	No
No. of Taxes on Typical Professional Service Firm ^a	6	2	2

Sources: CCH 2006 State Tax Handbook; Granholm Proposal; AEG Research

a. These firms most likely pay sales tax on tangible personal property, although we do not count it as a business tax here.

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