Michigan's Tax Overhaul

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Foster Swift Employment, Labor & Benefits E-News
August 3, 2011

On May 25, 2011, Governor Rick Snyder signed into law Public Acts 38 and 39 of 2011 (the “Act”), which make sweeping changes to Michigan’s business and individual tax landscape. Relevant to businesses, the Act repeals the complex and unpopular Michigan Business Tax (“MBT”) and replaces it with the new Michigan Corporate Income Tax (“CIT”) effective as of January 1, 2012. Relevant to individuals, the Act makes many changes, including taxing income from pensions and other types of retirement plans. This articles summarizes those changes.

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THE NEW CORPORATE INCOME TAX

Effective January 1, 2012, the CIT will impose a flat 6% tax on the Michigan apportioned income of businesses that are taxed as C corporations for federal income tax purposes. Unlike the MBT, the CIT will not apply to "pass-through" entities, such as S corporations and most limited liability companies. Moreover, a C corporation will be exempt from the CIT if its Michigan-apportioned annual gross receipts are less than $350,000 or its CIT liability is less than $100. Gross receipts will be apportioned based on the ratio of Michigan sales to total sales, as is currently done under the MBT. Ultimately, the replacement of the MBT with the CIT is estimated to relieve more than 95,000 Michigan businesses from the burden of filing a Michigan business income tax return and paying business taxes.

Since the CIT will apply only to C corporations, businesses that are taxed as C corporations may want to consider converting to an S corporation or another type of "pass-through" entity. This conversion could help reduce the business's effective income tax rate, and it might also help to reduce the owners' payroll or self-employment taxes. Several tax and business issues should be considered before pursuing such a conversion.

A downside of the CIT is that it will not retain most of the tax credits and deductions that are available under the MBT. One exception is the small business alternative tax credit, which will provide a credit to small businesses with gross receipts of less than $20 million and adjusted business income of $1.3 million or less, subject to certain limitations on the amount of compensation that may be paid to shareholders and officers. If a taxpayer qualifies for the credit, the taxpayer will receive a credit for the difference between the taxpayer's CIT liability and 1.8% of the taxpayer's adjusted gross income. Transitional relief may also allow taxpayers to continue to claim select credits under the MBT if they continue to file under the MBT, rather than the CIT. Businesses should consult their advisers regarding these potential tax credit opportunities.

The CIT will tax insurance companies and financial institutions differently from other businesses. The CIT's tax on insurance companies is identical to the tax such companies pay under the MBT. Financial institutions would also be subject to the same net capital tax imposed under the MBT, and the 0.29% net capital tax rate approximately equals the rate paid under the MBT, although the CIT will no longer allow financial institutions a deduction for goodwill.

CHANGES TO THE INDIVIDUAL INCOME TAX

The Act also makes important changes to Michigan's individual income tax. A summary of some of the significant changes follows.

Retirement Income. Under prior law, Michigan retirees were not taxed on: (i) income received from public pensions and retirement plans, and (ii) a portion of the income received from private retirement plans and pensions ($45,120 for single filers; $90,240 for joint filers). That will change effective January 1, 2012, as follows.

> *Persons Born Before 1946*. The Act does not change such persons' current treatment of retirement or pension income. Public pensions and other sources of public retirement income (including social security benefits) will continue to be exempt from state income tax. Likewise, the current exemption applicable to private pension and other sources of private retirement income will continue ($45,120 for single filers; $90,240 for joint filers).
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> *Persons Born During 1946 through 1952*. Such persons' deductions for: (i) public pension and retirement benefits, and (ii) private pension and retirement benefits, are limited to $20,000 for single returns ($40,000 for joint returns). Once such persons reach age 67, the deductions are available against all income. However, if such persons' total household resources exceed $75,000 ($150,000 for a joint return), no deductions are available. The deduction for social security benefits remains available.
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> *Persons Born After 1952*. Such persons' deductions for: (i) public pension and retirement benefits, and (ii) private pension and retirement benefits, are no longer available. However, the deduction for social security benefits remains available. When such persons reach age 67, they are eligible for a deduction of $20,000 ($40,000 for joint returns) against all types of income, although the separate deductions for social security benefits and the standard deduction are not allowed to persons who take the deduction. If household resources exceed $75,000 ($150,000 for a joint return), no deduction is available.

Individual Income Tax Rate. Beginning January 1, 2013, the individual income tax rate will be lowered to 4.25% (from 4.35%).

Homestead Property Tax Credit (the "HPTC"). The HPTC offsets the cost of property taxes for certain taxpayers. The Act makes a variety of changes to the HPTC.

> *Credit Unavailable to Certain Taxpayers*. The Act eliminates the HPTC for taxpayers whose taxable value of their homestead exceeds $135,000. For a new home, this limit equates to a sale value of $270,000.
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> *Phase-Out*. The HPTC will be phased-out starting at total household resources of $41,000 and will be eliminated once total household resources reach $50,000. Under current law, the HPTC phase-out does not begin until household income exceeds $73,600.

Deductions for Interest and Dividends. Effective January 1, 2012, taxpayers born after 1945 will no long be able to deduct a portion of their interest, dividend, and capital gains income. Under current law, the deduction is limited by a dollar amount only.

Standard Personal Exemption Phase-Out. The standard personal exemption will be phased-out for single taxpayers with household resources between $75,000 and $100,000, and for married couples filing joint returns with household resources between $150,000 and $200,000.

Earned Income Tax Credit. For tax years after 2011, the Michigan Earned Income Tax Credit will be reduced from 20% to 6% of the Federal Earned Income Tax Credit.

Credits. The Act eliminates most credits available under the individual income tax. For example, the Act eliminates all nonrefundable credits, including credits for city income taxes paid, donations to public entities, donated vehicles, food bank contributions, and college tuition and fees.

Withholding. Persons disbursing pension or retirement income must withhold income tax. Pass-through entities will be required to collect withholding on the distributive shares of members' business income.

If you have questions regarding the CIT, the changes made to the Michigan individual income tax law, or Michigan taxes generally, please contact Nicholas Oertel or Joel Farrar.