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BILL



ANALYSIS

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Senate Bill 315 (Substitute S-3 as passed by the Senate)
Sponsor: Senator Joanne G. Emmons
Committee: Finance

Date Completed: 7-7-95

RATIONALE

The 1986 Federal Tax Reform Act made numerous changes to the tax laws regarding individuals' Federal income taxes. For instance, before the 1986 Tax Reform Act, qualified unreimbursed business expenses were deducted in the computation of Federal adjusted gross income (AGI). These unreimbursed expenses were considered "adjustments to income", meaning that they were deducted from total income to produce a taxpayer's AGI. Because the State income tax form uses a taxpayer's AGI to begin the calculation of taxable income, this meant, in effect, that these business expenses were not subject to the State income tax. Pursuant to the 1986 Act, however, such expenses are accounted for as part of a taxpayer's itemized deductions, which are subtracted from a taxpayer's AGI after AGI has been determined rather than being subtracted as part of the AGI computation. This means, then, that unreimbursed business expenses that may be deducted from Federal taxes may not be deducted in the calculation of State taxable income. Some people feel that this change has been particularly burdensome to certain salespersons and employees who have unreimbursed business expenses, and that such expenses should be deductible from State taxable income.

The 1986 Federal Tax Reform Act also changed the exemption status of dependents. Prior to the 1986 Act, a person who was claimed as a dependent on another person's return was allowed to claim a personal exemption on his or her Federal return. Since the Income Tax Act allows personal exemptions only to the extent allowable on a taxpayer's Federal income tax form, dependents were allowed to claim a personal exemption from State income tax. The 1986 Federal Act provided, however, that anyone eligible to be claimed as a dependent on another

person's return could not claim an exemption on his or her own return; this meant that, regarding State income tax, a dependent with income could not claim a personal exemption, and was subject to State income tax for every dollar earned. Public Act 1 of 1988 amended the Income Tax Act to provide that a person who had a Federal adjusted gross income of \$1,500 or less and was not allowed to claim a personal exemption under the Internal Revenue Code was exempt from State income tax liability and did not have to file a return. This meant that a dependent who earned over \$1,500 had to pay State tax on the entire amount. Public Act 516 of 1988 provided that a dependent subject to the State income tax could deduct up to \$1,000 for the 1989 tax year and thereafter. (Example: A dependent who earned \$1,500 would not be taxed, but a dependent who earned \$1,800 would be subject to tax on \$800. $\$1,800 - \$1,000 = \$800$.) Earlier this year, the personal exemption was indexed to the rate of inflation by Public Act 3. It has been suggested that the \$1,000 deduction for dependents be increased to \$1,500, and that the deduction also be indexed to inflation.

CONTENT

The bill would amend the Income Tax Act to allow a deduction for certain business and trade expenses; and to increase the deduction that dependents may claim, and index the deduction to the rate of inflation.

The bill would allow a "qualified taxpayer" to deduct from taxable income, to the extent included in Federal adjusted gross income, those trade and business expenses of the taxpayer that are allowed as deductions in calculating AGI under Section 162(a) of the Internal Revenue Code. (Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred in

carrying on trade or business, including reasonable salaries for personal services; travel expenses away from home, including meals and lodging; and rentals or other payments for the use of property in trade or business.) Under the bill, a "qualified taxpayer" would be an "outside salesman" as that term was used under the former provisions of Section 62(2)(D) of the Internal Revenue Code as it read immediately before the Federal Tax Reform Act of 1986. (Under that section, a person could deduct from AGI expenses attributable to a trade or business carried on by the taxpayer if the trade or business consisted of the performance of services as a solicitor of business away from the employer's place of business.) The deduction would apply to tax years after 1994.

The bill provides that for tax year 1996 a person who is not allowed to claim a personal exemption under the Internal Revenue Code (i.e., a dependent), but who is subject to State income tax, could deduct \$1,500 from taxable income. The bill provides that for tax years beginning after 1996 the deduction would be indexed to inflation; that is, the amount would be adjusted each year to reflect the annual average percentage increase or decrease in the Detroit Consumer Price Index for the preceding year. The adjusted amount would have to be rounded to the nearest \$50.

MCL 206.30

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Because of changes made by the Federal Tax Reform Act of 1986, some taxpayers found that their treatment under the State Income Tax Act had worsened. Many persons who were allowed to exclude business expenses found that their State tax liabilities increased substantially because these items were now excluded from the calculation of AGI. This change has been particularly unfair under the State income tax to salespersons and employees who have unreimbursed business expenses.

For example, a company employee who has qualified business expenses that are reimbursed by the company has no tax consequences, if the expenses are allowed under the Internal Revenue Code and the reimbursement does not exceed the expenses. An independent salesperson not

employed by a company may deduct expenses in determining business income (which is a component of the AGI calculation), and thus those expenses are excluded when the person calculates his or her State income tax. A salesperson or employee who works for a company that does not reimburse business expenses, however, is unable to exclude his or her expenses from the AGI calculation; unreimbursed business expenses must be included under miscellaneous deductions that are a component of the Schedule A calculation of itemized deductions. Because itemized deductions are subtracted after AGI has been determined, this means that these taxpayers are unable to exclude their unreimbursed business expenses in determining their State income tax. This has for too long been a sore point for persons with unreimbursed business expenses, because it causes two different tax results for people who have similar jobs and income; in effect, employees or salespersons with unreimbursed business expenses are punished by the parameters of their employment status and for no other reason. The bill would correct this injustice.

Supporting Argument

Earlier this year the State found itself in the enviable position of having a projected substantial revenue surplus. The Governor proposed that the State should use the opportunity not only to return the surplus to the taxpayers but also to enact permanent tax cuts. Part of the tax package that eventually was approved included indexing the personal exemption to the rate of inflation, thus offering lasting tax relief by ensuring that inflationary increases would not erode the value of the personal exemption. The bill, by indexing the dependent exemption to the rate of inflation, would offer the same protection and lasting benefit to those individuals who have income but are claimed as a dependent by another taxpayer. In addition, by raising the deduction for dependants to \$1,500, the bill would equalize the tax treatment of those who earn that amount or less (and are exempt from State income taxes) and those who earn more than \$1,500 (who now must pay taxes on the amount over \$1,000).

Opposing Argument

Although the bill would restore deductions that some taxpayers lost long ago due to changes in Federal tax law, it must be questioned whether the bill would be fair to all concerned. Passage of the 1986 Federal Tax Reform Act resulted in many changes for the State's taxpayers and caused an increase in revenue collections under the State

income tax. In response to this increase in taxation, a broad-based solution was adopted to minimize increased collections by increasing the personal exemption for all taxpayers except dependents, and exempting those dependents with an income under \$1,500. There could be numerous examples in which quirks in the Income Tax Act, as affected by the changes in Federal taxes, have caused individual groups of taxpayers to experience slight or moderate tax increases. Rather than addressing the problems of each group, lawmakers decided to return money to the taxpayers by trying to reduce everybody's tax liability. If this bill passed, it clearly would favor those with unreimbursed business expenses while doing nothing for other taxpayers. Further, the bill would have a substantial fiscal impact. In view of the broad tax cuts recently enacted, perhaps it would be wise for the State to take some time to assess its revenue picture.

Response: The issue is whether the State should return equity to those who, through no effort of the State or its decision-makers, had their taxes increased. If one group of taxpayers is treated differently than another group, the laws should be adjusted to equalize the situation. The bill simply would promote equity in the Income Tax Act and consistency with past tax policy.

Legislative Analyst: G. Towne

FISCAL IMPACT

This bill would reduce income tax revenue by an estimated \$28 million in FY 1995-96 and \$40 million in FY 1996-97. The proposed new deduction for unreimbursed business expenses would reduce income tax revenue by an estimated \$28 million in FY 1995-96 and \$29 million in FY 1996-97. Increasing the so-called "kiddie" exemption, which is granted primarily to children and students who are also being claimed as a dependent by some other taxpayer, from \$1,000 to \$1,500 beginning in the 1996 tax year, would reduce income tax revenue by an estimated \$11 million in FY 1996-97. For tax years beginning in 1997, this "kiddie" exemption would be indexed to the Detroit Consumer Price Index, which, at current rates of inflation, would further reduce income tax revenue by an estimated \$1 million beginning in FY 1997-98. These reductions in income tax revenue would affect several areas of the State's overall budget: General Fund/General Purpose revenue would be reduced by an estimated \$22 million in FY 1995-96 and \$31 million in FY 1996-97, School Aid Fund revenue would be reduced by an estimated \$4 million in FY

1995-96 and \$6 million in FY 1996-97, and revenue sharing would be reduced by an estimated \$2 million in FY 1995-96 and \$3 million in FY 1996-97.

Fiscal Analyst: J. Wortley

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.