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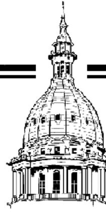

BILL ANALYSIS

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Senate Bill 361 (as enacted) **PUBLIC ACT 460 of 2018**
Sponsor: Senator Darwin L. Booher
Senate Committee: Finance
House Committee: Tax Policy

Date Completed: 3-4-19

CONTENT

Senate Bill 361 amended Chapter 13 of the Income Tax Act, which imposes a franchise tax on financial institutions, to do the following:

-- **Provide that a financial institution's tax base is the total equity capital of the financial institution or top-tiered parent entity, in the case of a unitary business group of financial institutions, subject to several deductions.**
-- **Define "total equity capital" and "top-tiered parent entity".**
-- **Require the tax base to be determined as of the close of the tax year, rather than based on a five-year average, beginning after December 31, 2020.**
-- **Specify that, if a United States person included in a unitary business group of financial institutions or a financial institution combined return is subject to the Corporate Income Tax or the tax on insurance companies, its business income or equity capital must be eliminated from the total equity capital of the unitary business group.**

The bill is effective for tax years beginning after December 31, 2018, and took effect on December 27, 2018.

Part 2 of the Act provides for the Corporate Income Tax (Chapter 11), a tax on insurance companies (Chapter 12), and a tax on financial institutions (Chapter 13). Under Chapter 13, every financial institution with substantial nexus in the State is subject to a franchise tax. The tax is imposed upon the tax base of the financial institution after allocation or apportionment, at the rate of 0.29%.

Previously, a financial institution's tax base was its net capital, which meant equity capital as computed in accordance with generally accepted accounting principles (GAAP) less the average daily book value of U.S. obligations and Michigan obligations. Net capital did not include up to 125% of the minimum regulatory capitalization requirements of a person subject to the tax imposed under Chapter 12.

Under the bill, instead, a financial institution's tax base is the total equity capital of the financial institution or top-tiered parent entity in the case of a unitary business group of financial institutions, subject to the deduction of the following items before allocation or apportionment:

-- The average daily book value of United States obligations owned during the tax year by members of the unitary business group.

-- The average daily book value of Michigan obligations owned during the tax year by members of the unitary business group.
-- The equity capital of a person that was subject to the tax imposed under Chapter 12, not to exceed 125% of the minimum regulatory capitalization requirements of the member.

"Equity capital" means equity capital as calculated in accordance with GAAP.

The bill defines "total equity capital" as the same amount reported by the financial institution or top-tiered parent entity, in the case of a unitary business group of financial institutions, and as reported for the tax year on any of the Federal forms listed in the bill and designated by the Federal Financial Institutions Examination Council (FFIEC), that are filed with the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Federal Reserve System. "Top-tiered parent entity" means the highest-level entity within the unitary business group that is required to file with a regulatory agency under the standards prescribed by the FFIEC.

Previously, the Act required net capital to be determined by adding a financial institution's net capital as of the close of the current tax year and preceding four tax years and dividing the resulting sum by five (except as provided for a financial institution that had not been in existence for five years). The bill, instead, refers to equity capital, and requires equity capital to be determined as of the close of the tax year beginning December 31, 2020.

Under the bill, if a United States person included in a unitary business group of financial institutions or a financial institution combined return is subject to the Corporate Income Tax or the tax imposed under Chapter 12, any business income or equity capital attributable to that person must be eliminated from the total equity capital of the unitary business group, and any sales or gross business attributable to that person must be eliminated from the apportionment formula under Chapter 13.

The bill states, "The provisions of section 655 of the income tax act…as amended by this amendatory act, are curative and intended to clarify existing law and accurately reflect the interpretation and application of those provisions in accordance with the notice to taxpayers dated November 21, 2016, regarding 5-year averaging calculation of net equity capital for financial institutions."

MCL 206.651 & 206.655

BACKGROUND

On November 21, 2016, the Department of Treasury issued a notice stating that it would no longer calculate net capital for years before the year of combination of two or more financial institutions into one using both the surviving and acquired entities' net capital. The notice began by stating that financial institutions calculate their Corporate Income Tax net capital tax base by averaging net capital over a five-year period (or the number of years of existence if fewer than five). The notice described the tax treatment of combined financial institutions at the time the notice was issued. Specifically, when two or more financial institutions combined, the law required the combined institution to be treated as if it had been a single financial institution for the entire tax year in which the combination occurred and for each tax year after the combination. The treatment of entities in the years before the combination for purposes of calculating net capital for the surviving and acquired entities for tax years before the year of combination had to be included in the calculation of the tax base.

The notice rescinded that policy and stated that when two or more financial institutions combine, "only the surviving financial institution's net capital for the years prior to the

combination is used to calculate the surviving entity's tax base". Thus, for the year before the combination, the surviving financial institution must use only its own books and records to calculate the five-year look-back averaging calculation. In the year of the acquisition and for subsequent years, the surviving financial institution must merge its books and records with those of the acquired institution and the combined books and records must be used to calculate the net capital tax base.

Legislative Analyst: Drew Krogulecki

FISCAL IMPACT

The bill will increase the volatility of General Fund revenue, which means that in some years the State will receive more than under previous law and in other years it likely will receive less. However, over the long run, one change will increase revenue by an unknown, and likely minimal, amount.

Revenue volatility will be increased because the bill moves calculation of the tax base from a five-year average to a single-year value. By using an average, the calculation created a relatively stable tax base under previous law, with "low years" not bringing the tax base down by as much as they would otherwise, and "good years" not bringing it up by as much as they would otherwise. By switching to a single-year tax base, the bill generally will result in the General Fund receiving more revenue than under previous law when financial conditions for banks are improving, and less when conditions are declining. Over the long run, the change will not likely alter the total revenue received by the State.

Fiscal Analyst: David Zin

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