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BILL ANALYSIS

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Senate Bill 361 (as passed by the Senate)
Senate Bill 362 (Substitute S-1 as passed by the Senate)
Sponsor: Senator Darwin L. Booher
Committee: Finance

Date Completed: 11-14-18

RATIONALE

Part 2 of the Income Tax 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 on the tax base of the financial institution after allocation or apportionment, at the rate of 0.29%. Apparently, several issues have been identified regarding difficulties in the filing and the administrative processing of business taxes banks remit to the State. To address these issues, some have suggested amending Chapter 13 of the Income Tax Act to clarify how to calculate a financial institution's tax liability, among other things.

CONTENT

Senate Bill 361 would amend 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 would be 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.**
- **Specify that, if a United States person included in a unitary business group of financial institutions or a financial institution combined return were subject to the Corporate Income Tax or the tax on insurance companies, any business income or equity capital attributable to that person would have to be eliminated from the total equity capital of the unitary business group, and any sales or gross business attributable to that person would have to be eliminated from the apportionment formula under Chapter 13.**

Senate Bill 362 (S-1) would amend Chapter 13 of the Income Tax Act to revise the apportionment formula for a financial institution with respect to gross business attributable to the foreign business of a controlled foreign corporation, and for a unitary business group of financial institutions that acquired or disposed of members during the tax year.

The bills would be effective for tax years beginning after December 31, 2017.

Each bill states, "The provisions of section 651 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." (Senate Bill 361 would amend Section 651, which contains definitions for Chapter 13.)

The bills are tie-barred.

Senate Bill 361

Currently, a financial institution's tax base is its net capital, which means 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 does 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 would be 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, to the extent that they were included in total equity capital:

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

For purposes of the last item, "equity capital" would mean equity capital as calculated in accordance with GAAP.

The bill would define "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" would mean 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.

The Act requires 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 has not been in existence for five years). The bill, instead, would require net capital to be determined as of the close of the tax year.

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

Senate Bill 362 (S-1)

Under Chapter 13, if a financial institution's business activities are subject to tax both within and outside of Michigan, the financial institution's tax base must be apportioned to this State; this is done by multiplying the tax base by a fraction called the gross business factor.

As a rule, the numerator of this fraction is the total gross business of the financial institution in this State during the tax year, and the denominator is its total gross business everywhere during the tax year. The bill states that the denominator would have to include any gross business attributable to the foreign business of a person that was a foreign operating entity or a foreign person or attributable to operations outside of the United States.

For a unitary business group of financial institutions, the bill would require the gross business factor to include the gross business of all members of the unitary group during the tax year. For members that the group acquired or disposed of during the tax year, the gross business factor would have to include the gross business of the part-year member for that portion of the tax year during which the member met the control and relationship parameters under Section 611(6) of the Act, or for the portion of the tax year for which the member filed as a part of an affiliated group under Section 691(2).

(Section 611(6) defines "unitary business group" as a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, one of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights, and that has business activities or operations that result in a flow of value between or among members included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. The term includes an affiliated group that makes the election to be treated, and to file, as a unitary business group under Section 691(2).

Section 691(2) permits a person that is part of an affiliated group (as defined in the Act) to elect to have all of the persons that are included in the affiliated group to be treated as a unitary business group.)

MCL 206.651 & 206.655 (S.B. 361)
206.653 & 206.657 (S.B. 362)

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.

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

The bills are important to clarify several issues and provide more certainty regarding the calculation of a financial institution's tax liabilities to the State. First, Michigan's current method to determine and report capital is complicated and confusing. The bills would resolve this by using Federally

reported capital or the net equity of a "top-tiered parent company" member, creating a known tax base.

Second, the five-year tax base averaging principle is confusing when applied to financial institutions that merge or acquire other financial institutions. Although the Department of Treasury's notice (described in **BACKGROUND**) sought to address this issue, the bills would create a permanent solution to this problem by requiring the tax base to be determined as of the close of the tax year, rather than based on a five-year average.

Moreover, the bills would ensure that the taxation of foreign operations and profits was consistent across industries. The Corporate Income Tax is a "water's edge" tax (meaning that it does not tax foreign operations). The financial institution tax should be applied the same way because it is a companion to the Corporate Income Tax. No other corporate entity is taxed beyond U.S. boundaries. It is only fair that both taxes be applied consistently.

Response: The Corporate Income Tax and the financial institution tax are different and should be treated separately. The Corporate Income Tax is a tax based on the income of entities based in the United States. The financial institution tax, however, is based on the equity of entities based in the United States and capital in financial statements. Foreign equity, while housed overseas, does appear on financial statements and is listed as an asset. By removing foreign assets of U.S. entities from the base of the tax, the bills would erode the tax base and could encourage financial institutions to avoid taxation by investing more capital overseas.

Legislative Analyst: Drew Krogulecki

FISCAL IMPACT

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

Revenue volatility would be increased because the bills would move calculation of the tax base from a five-year average to a single-year value. By using an average, the calculation creates a relatively stable tax base under current 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 bills generally would result in the General Fund receiving more revenue than under current law when financial conditions for banks are improving, and less when conditions are declining. Over the long run, the change would not likely alter the total revenue received by the State.

Fiscal Analyst: David Zin

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