CITIZENS RESEARCH COUNCIL OF MICHIGAN

"The right to criticize government is also an obligation to know what you're talking about."
Lent Upson,
First Director of the Citizens Research Council

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Flawed Language Will Nullify Income Tax Cut in 2024

In a Nutshell

- With the state's financial books for FY2022 now closed, a formal announcement came last week that the state income tax rate would drop from 4.25 percent to 4.05 percent for tax year 2023 due to a rate cut trigger added to state law in 2015.
- However, a new Attorney General legal opinion has determined that any rate cut would be temporary, with the rate returning to 4.25 percent for tax year 2024.
- Our "plain English" interpretation of what appears to be flawed statutory language also suggests the rate will very likely need to return to 4.25 percent in 2024.

The State of Michigan closed its financial books on Fiscal Year (FY)2022 last week, and, after two months of uncertainty, the newly-released financial report confirmed what state economic forecasters had suggested back in January: that an income tax rate trigger mechanism added to state law as part of 2015 road funding legislation would reduce the state's income tax rate from 4.25 percent to 4.05 percent for tax year 2023.

However, a new wrinkle developed just a day before the report's release. A legal opinion from Attorney General Dana Nessel determined that the statutory language that created the income tax trigger should result in only a temporary rate cut for 2023. The rate would legally return to 4.25 percent for tax year 2024. That finding has drawn the ire of many legislative Republicans who denied immediate effect to House Bill 4001 last month in an effort to maintain a permanent income tax rate cut by preventing a planned GF/GP transfer in the bill to fund the Governor's proposed one-time $180 income tax rebates.

So, what's the issue with the 2015 language? We are not attorneys here at the Research Council, so we have no unique expertise in case law regarding the interpretation of statutory language. However, we are most definitely in the business of reading and analyzing Michigan statutes. With that, here is our own take on what this language says. Sneak preview: while there's room for argument with elements of the Attorney General's opinion, we agree with her conclusion.

For reference, here is the relevant language from the Income Tax Act (MCL 206.51).

(1) …there is levied and imposed under this part upon the taxable income of every person other than a corporation a tax at the following rates in the following circumstances:
(a) On and after October 1, 2007 and before October 1, 2012, 4.35%.
(b) Except as otherwise provided under subdivision (c), on and after October 1, 2012, 4.25%.
(c) For each tax year beginning on and after January 1, 2023, **if the percentage increase in the total general fund/general purpose revenue from the immediately preceding fiscal year is greater than the inflation rate for the same period and the inflation rate is positive** (emphasis added), then the current rate shall be reduced by an amount determined by multiplying that rate by a fraction, the numerator of which is the difference between the total general fund/general purpose revenue from the immediately preceding state fiscal year and the capped general fund/general purpose revenue and the denominator of which is the total revenue collected from this part in the immediately preceding state fiscal year…

The section includes two important subdivisions. Subdivision (b) sets the current 4.25 percent income tax rate; and it provides that the rate remains at 4.25 percent "except as otherwise provided in subdivision (c)". Subdivision (c) then defines how rate reductions under the trigger are to be determined each year using a formula that considers General Fund/General Purpose (GF/GP) revenue growth and compared to the national inflation rate. Notably, however, subdivision (c) is also predicated on a specific condition; the adjustments in the subdivision are implemented only when total GF/GP growth from the prior fiscal year exceeds CPI inflation as measured from the prior fiscal year.

What is the "Current Rate"?

In interpreting the language, two critical questions arise. The Attorney General's opinion focuses mostly (though not exclusively) on the first of these two questions: what did the legislature mean by "current rate"? The language prescribes that, whenever GF/GP revenue growth exceeds inflation during the immediately preceding state fiscal year, the "current rate" is to be reduced by an amount derived from the statutory formula.

The Attorney General's opinion finds that the "current rate" should legally be defined as the default baseline 4.25 percent rate established in subdivision (b) citing the dictionary definition of the word "current" as "existing at the present time". It interprets subdivision (c) as establishing an annual process to determine whether a reduction is warranted from that 4.25 percent baseline rate and finds that whether a triggered rate reduction has occurred in a prior year "is of no consequence to the annual determination made under subsection (1)(c)."

Here, there's certainly room for argument. The rate trigger determination for tax year 2024 will be made about a year from now in early 2024. At that time, the income tax rate – as everyone now agrees – will be 4.05 percent. A strong argument can at least be made that "current rate" should mean the reduced rate of 4.05 percent when this process is followed next year. That interpretation suggests that the starting point for any further reduction rate reduction under the formula would be 4.05 percent, not 4.25 percent.

What about the "Triggering Event"?

Regardless of the proper definition of "current rate" though, another critical issue is at play. The whole rate reduction process is predicated on a condition: that GF/GP revenue growth exceeds inflation for the most recently completed state fiscal year (see the bolded language above). If it doesn't, then there is no calculation to be made. The Attorney General's opinion refers to this language as a "triggering event".

And if there's anything that's a near certainty related to next year's income tax trigger calculation, it's this: that triggering event will not happen. Even with no additional tax relief, GF/GP revenue was projected to fall in FY2023. The latest state revenue forecast in January found the phenomenal GF/GP revenue growth experienced in FY2022 that triggered the rate cut was an aberration – likely fueled at least in part by the timing of a new flow-through entity tax paid by certain business entities on income allocated out to the entity's owners/members. GF/GP revenue was estimated to drop by around $427 million (2.8 percent) in FY2023, returning to a longer-run trend.

More significantly, House Bill 4001 enacted in March will reduce revenues much further. The combination of the now-temporary income tax rate cut; the changes to the treatment of retirement income; an enhanced Earned Income Tax Credit; the redirection of Corporate Income Tax revenue from the GF/GP to special economic and community development funds; and other smaller credits will carve another $1.5 billion or more out of GF/GP revenue. All told, GF/GP revenue is expected to drop by more than $2 billion; that's a decline of around 12-13 percent from FY2022. In short, GF/GP growth for the trigger formula will be very negative and well below the inflation rate. The "triggering event" won't occur.

So, what does that mean for the tax rate in 2024? In our opinion, the only way to read the language is there's no longer any need for the annual calculation prescribed in subdivision (c). Effectively, subdivision (c) is now moot since the condition on GF/GP growth exceeding inflation is not met. If you're the Department of Treasury following the rules of the law next year, you can just stop reading subdivision (c) after the second comma. What the "current rate" represents is no longer even relevant; neither are all the elements of the trigger formula.

Critically, while subdivision (c) spells out what to do when the triggering event occurs, it is silent on what is supposed to happen if that event does not occur (so is the rest of the law). It doesn't say "maintain the reduced rate" or "go back to the old rate" or anything else. That takes us back to subdivision (b), which says the rate is to be 4.25 percent "except as otherwise provided in subdivision (c)".

In our mind, the fairest interpretation of this language is that the income tax rate reverts to 4.25 percent in any tax year for which the triggering event – annual GF/GP growth exceeding inflation – does not occur. That will most certainly include tax year 2024.

Looking Ahead: What Now?

Let's be clear about a couple of important things. First, this interpretation implies nothing about whether a permanent cut to the income tax rate is right or wrong from a policy standpoint; it's simply the clearest reading of the statutory language. Second, it's abundantly clear that this is not what the legislature intended to enact back in 2015. We were actively tracking and analyzing that legislation then. No one was saying or even implying that the trigger mechanism was meant to bring temporary rate cuts; it was a general understanding that any rate cut would be permanent.

In the end, it's becoming clear this language is flawed. It does not create the trigger that was envisioned by the legislature that created it. It's certainly the prerogative of the current legislature to fix the language in subdivision (c), but that seems very unlikely given the shift in the partisan control of both chambers.

No doubt, this will be a highly contentious issue. Republicans stood their ground in denying immediate effect to House Bill 4001; thus preserving the perceived permanent income tax rate cut. A court challenge to the Attorney General's opinion seems more likely than not. But, barring some revenue miracle beyond anything we've seen during the recent revenue boom, our reading suggests that any litigants will have an uphill battle in convincing a court that the language above implies a permanent tax cut.

ABOUT THE AUTHOR

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Bob is in his second stint with the Citizens Research Council, having worked for the organization from 2013 to 2015. He has spent most of his time in state government, having worked in the Office of Health and Human Services – State Budget Office and as Associate Director for the non-partisan Michigan House Fiscal Agency (HFA). He has extensive expertise and has provided non-partisan advice and analysis on state policy and budget matters in areas including corrections, human services, and transportation. Prior to joining HFA, he was a research assistant and project manager from 1994 to 1996 for Public Policy Associates, a Lansing-based policy research and consulting firm. He also served for two years within the Michigan Department of State working on department budget and financial issues.

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