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Summary Digest of Michigan Tax Study Staff Reports

As a public service the Research Council has prepared this digest of a staff report to the Michigan State Tax Study Committee. The Committee is considering basic changes in the state's tax structure and these digests have been prepared to inform the public as to what is being considered by the Committee. It should be emphasized that the material presented is a digest of the staff report to the Committee and does not represent the findings or opinions of the Michigan Tax Study Committee, its citizens advisory committee, or the Research Council.

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THE TAXATION OF INTANGIBLE PERSONAL PROPERTY IN MICHIGAN

INTRODUCTION

The modern general property tax is based historically on the assumption that all types of property (real, tangible personal, and intangible personal) are homogeneous and should be taxed uniformly. However, those who have given the problem of taxing intangibles close theoretical attention are in general agreement that to tax both the tangible asset and its representative claim results in discriminatory double taxation.

The dissatisfaction with both the theoretical justification for a tax on intangibles and its administrative weaknesses eventually led to a movement among the states for special treatment of intangibles. No two states tax intangibles in exactly the same way, but there are two broad approaches:

- 1) The taxation of intangibles at a special low rate based either on income or value; or
- 2) The exemption of intangibles from the property tax and the taxation of income resulting from their ownership under general income tax laws.

The Michigan Intangibles Tax Act, adopted in 1939, imposes a specific low-rate tax at the state level on intangibles in lieu of taxing such property at the local level under the general property tax laws. The Michigan Intangibles tax is classified as a specific tax rather than an ad valorem tax, thus excluding it from the constitutional uniform rule of taxation and 15 mill limit.

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THE MICHIGAN INTANGIBLES TAX LAW

The Base

The objective of the intangibles tax is to reach taxpaying ability as represented by the ownership of intangible personal property. Stocks, bonds, bank deposits, certificates of indebtedness, mortgages, debentures, annuities, accounts and notes receivable, land contracts, money on hand or in transit, and all other credits and evidences of indebtedness are subject to the tax.

Exemptions

There are several major groupings of exemptions to the intangibles tax:

- 1) Intangibles owned by charitable and other non-profit institutions; insurance companies; railroad, telegraph and telephone companies; and, banks, trust companies, building and savings and loan associations, and credit unions.
- 2) Specific intangibles which are exempt regardless of who owns them including: Michigan state and local bonds and U.S. bonds; assets of certain pension, profit sharing, and trust plans; certain types of annuities and insurance policies; and other specified intangibles.
- 3) There are special exemptions for the following: owners of bank deposits if the bank elects to pay the tax; part year owners receive a partial exemption; intangibles owned by partners are exempt if the partnership pays the tax; and, other intangible property which if taxed under the intangibles act would be subject to double taxation.

Rates

There are four different rates, varying with the type of property and whether or not it produces income:

- 1) Income received from intangibles, such as dividends and interest, is taxed at the rate of $3\frac{1}{2}$ per cent.
- 2) Non-income producing property is taxed at a capital levy of $\frac{1}{10}$ of one per cent of the face or par value, or for no par stocks, the contributed value. If the property produces income the tax must be at least $\frac{1}{10}$ of one per cent of the face, par, or contributed value, thus providing a basic or minimum rate on income producing property.
- 3) A rate of $\frac{1}{25}$ of one per cent applies to bank deposits, the paid-in value of shares and deposits of building and loan and saving and loan associations, and money on hand or in transit, whether located in or out of the state. Collection at the source is used in the case of financial institutions. This rate also applies to income producing accounts and notes receivable, less payables.

- 4) The rate on the shares of state and national banks and trust companies is 5½ mills, which is collected from the banks.

The intangibles tax is actually a combination of an income tax and a capital levy. If the income is high enough, the effect is that of an income tax. If the income yield is less than 2.857 per cent of the face, par, or contributed value of the property, the tax becomes a capital levy of 1/10 of one per cent of such value, which is equivalent to the 3½ per cent tax on an income yield of 2.857 per cent.

After giving effect to the \$20 deduction per taxpayer, there is no tax to pay on an income of \$571 or less on a yield of over 2.857 per cent of face, par, or contributed value, or when \$20,000 or less of stock valued at par yields less than 2.857 per cent. The intangibles tax is biased in favor of intangibles which do not yield a return or which have a low return.

Tax Deduction

The intangibles tax law permits a deduction of \$20 for each taxpayer. This is a deduction from the tax. Michigan's \$20 tax deduction is unique; no other state allows a similar deduction. And, of course, no deduction of this type is allowed under the general property tax laws. If this deduction were eliminated completely revenue from this source would increase by \$1.3 million (\$20 from each of 65,000 taxpayers) plus the revenue gain from new taxpayers who would become taxable if the \$20 deduction were eliminated. The effect of the tax deduction of \$20 is to make both the income and capital levy rates progressive when the tax payment is related to either the par value of the stock or to income.

Tax Situs

The two basic principles concerning tax situs, both of which are followed in Michigan, are as follows: 1) intangible property is taxable at the domicile of the owner; and 2) a state may tax intangibles which have acquired a business situs within its boundaries, making it possible to tax the intangibles of a non-resident or of a foreign corporation. All businesses operating both within and outside of the State must determine their tax liability by the same formula, which is an average of the following three percentage ratios, separately computed: 1) Michigan sales to total sales, 2) Michigan physical properties to total, and 3) Michigan payrolls to total payrolls.

Yield

The Michigan intangibles tax currently is producing \$23.7 million per year in revenue. The intangibles tax produces only about three per cent of total state-collected taxes, but it is an important minor source of revenue and is more productive than the use, utilities, inheritance, and severance taxes.

The following is an intelligent guess as to the effect on yield of certain changes in rates and basis: 1) an increase in the income rate of one per cent (up from 3½ to 4½

per cent) would increase the yield by \$4 – 4.5 million; 2) a one mill increase in the capital levy (up from 1 mill to 2 mills) would increase the yield by \$4 million; and 3) doubling the 1/25 of one percent rate on bank deposits, etc., would increase the yield by \$3 million.

Distribution of Revenues

The original 1939 intangibles tax act distributed two-thirds of the proceeds to cities, villages, and townships on a population basis and one-third was retained by the state. The rationale for this distribution was that the new tax removed a source of revenue from local units and, consequently, they were entitled to a share of the proceeds.

In 1951 the distribution was amended to limit the amount to be distributed to local units. Since 1953 local units have received \$9.5 million a year and receipts in excess of this amount are retained by the state. The portion retained by the state is first earmarked for the payment of mental hospital bonds, with the residual going to the general fund. The distribution of a fixed amount of \$9.5 million to local units operates in favor of the state and to the disadvantage of local units in periods of rising revenues, while the converse would be true in years of falling collections.

The allocation of intangibles money to local units is made on a per capita basis according to the last federal census, which does not follow the presumed rationale for distribution which is to compensate local governments for the loss of tax base. As a result there is a considerable redistribution of income from counties with a relatively high ownership of intangible personal property to counties with a lower level of ownership.

INTERSTATE COMPARISONS

There is a wide variation among the states in the methods used to tax intangibles. Six states still tax intangibles on the local level as part of the system of taxing the ownership of general property. Thirteen states substantially exempt intangibles from the property tax and include income from intangibles under general personal and corporate income taxes. Twenty-nine states, like Michigan, have developed some special way to tax intangibles. However, tax methods are not this clear-cut because some states which exempt intangibles have no general income tax laws, and some states which have income tax laws also tax intangibles on a specific or ad valorem basis.

No state taxes intangibles in exactly the same way as any other state. In the eight states chosen for special attention in the Michigan Tax Study only Indiana and Ohio have levies which are comparable to Michigan's tax. Illinois taxes intangibles at the local level under general property tax laws. New Jersey, New York, and Wisconsin exempt intangibles. Pennsylvania, like Michigan, has a special method of taxing intangibles, but only certain intangibles are taxed on the county level. The Ohio and Michigan intangibles taxes are fundamentally the same.

Comparative Burdens In the eight states, only four of which have special intangibles taxes, the general picture is that Ohio's tax burden on intangibles is about double Michigan's, while Indiana's burden is about one-half Michigan's. Pennsylvania falls about midway between Indiana and Michigan.

Comparative Intangibles Tax Burdens in
Indiana, Michigan, Ohio, and Pennsylvania, 1955

	<u>Intangibles Tax Collections</u>	<u>Intangibles Collections as Percentage of Total State Revenue</u>	<u>Intangibles Collections as Percentage of Property Income</u>	<u>Intangibles Collections as Percentage of Personal Income</u>	<u>Per Capita Intangibles Tax Collections</u>
Indiana	\$ 4,666,000	1.21	.58	.06	\$1.08
Michigan	18,186,000	1.72	1.20	.12	2.60
Ohio	48,271,000	4.25	2.31	.26	5.40
Pennsylvania	19,626,000	1.60	.72	.09	1.80

Source: Supplement to Survey of Current Business, Personal Income by States Since 1929 (Dept. of Commerce, 1956); Compendium of State Government Finances in 1956 (Dept. of Commerce, 1956).

PARTICULAR ISSUES

Accounts Receivable

An account receivable is an obligation owing to a person on open account and is taxable under the intangibles tax act (with an off-set for accounts payable). Money on deposit in a bank, however, is not considered to be an account receivable under the intangibles act. Thus, while there is a similarity between accounts receivable and bank deposits, they receive dissimilar treatment under the intangibles act. There are two alleged inequities in this dissimilar treatment:

- 1) Since the tax rate on accounts receivable is higher than that on cash and deposits, firms extending credit and having a relatively high volume of accounts receivable are discriminated against compared to businesses which do more of a cash business.
- 2) Discrimination exists because accounts payable are deductible only from accounts receivable and not from cash and deposits. Thus, industries which have a relatively high volume of accounts payable at the same time that cash and deposits are also high, are prejudiced by not being permitted to deduct accounts payable from cash and deposits.

Both of these alleged inequities should be qualified, however, by mention of the fact that the tax on bank deposits of 1/25 of one per cent is collected at the source from the banks in Michigan, and the vast majority of the commercial banks do not explicitly pass the tax to the depositors.

The Taxation of Banks and Other Financial Businesses

The application of an intangibles tax to banks and other financial businesses involves a special situation, because intangibles for these firms are the source of their gross operating income. To make a bank's case comparable to that of individuals and other firms, which receive intangible income principally in the form of net rather than gross income, it would be necessary to deduct a bank's operating costs from its gross receipts. This is the reason intangible personal property belongings to banks, building and loan and savings and loan associations and trust companies was made exempt from taxation under the original intangibles act. Instead, these firms were only taxed on their shares. Another unusual feature of taxing banks is provided by Federal law which restricts the taxation of national banks to several methods in order to ensure that state statutes will not discriminate against national banks.

Michigan ranks as a moderate state in the taxation of insured commercial banks. The ratio of state taxes to net profit is 11.00 per cent in Michigan which is very close to the ratio for all states of 10.45 per cent. Michigan also ranks about in the middle of those states selected for particular comparison in the Michigan Tax Study. Indiana, New Jersey, and Ohio have heavier burdens of state taxes on banks than Michigan, while Illinois, New York, Pennsylvania, and Wisconsin have lighter burdens.

The present burden of taxes under the intangibles and corporate privilege taxes on companies engaged in lending money is varied as is shown in the following table.

Intangibles Tax and Corporate Privilege Tax Burdens on Companies Engaged in Lending Money

<u>Type of Company</u>	<u>Intangibles Tax</u>	<u>Corporate Privilege</u>
National and State Banks	5 ½ mills on shares 1/25 of one % of deposits	Exempt
Trust Company	5 ½ mills on shares	Exempt
Finance and small loan companies	3½% of income from intangibles or 1/10 of one % capital levy	4 mills on book value
Building and loan associations (state) and Savings and Loan associations (federal)	1/25 of one % on shares	¼ mill
Credit Unions (state and federal)	Exempt	Exempt
Unincorporated businesses	3½% of income from intangibles or 1/10 of one % capital levy	Exempt

With such varied tax treatment of competing money capital, there is the likelihood of inequities between firms. However, some degree of discrimination is probably desirable, since all firms in the money market do not operate under the same circumstances

or conditions. A comprehensive study of the taxing of financial institutions in Michigan completed in 1954 arrived at the conclusion that the tax burden for such companies in Michigan was relatively low and inequitably distributed. It was determined that in Michigan during 1948 the ratio of state taxes to net income was 7.3 per cent for banks, 1.7 per cent for building and loan associations, and .19 per cent for insurance companies. It was the conclusion of this study that inequalities of tax burden exist between building and loan associations and other types of financial institutions.

Face, Par, or Contributed Value

There are four basic inequities in the taxation of intangibles. The intangibles tax favors:

- 1) stocks which do not produce income
- 2) stocks with a low par value
- 3) stockholders of companies which retain a relatively large percentage of their earnings
- 4) stockholders as opposed to bondholders.

The basic reason for all of these discriminations is that face, par, or contributed value constitutes an inadequate measure of capital stock values. Either market or book value would be an improvement as a base for the capital levy tax. Market value appears to be the superior base.

In addition to making the application of the intangibles tax more equitable, substituting either market or book value of stock as a basis for the capital levy would result in more revenue. However, there are some doubts that may be raised as to the constitutionality of using either market or book value as a basis of the tax.

Administration

There is the likelihood that a significant number of Michigan citizens do not pay the tax out of ignorance or willful failure to file. While it appears likely that the employment of more resources in intangibles tax auditing efforts would be a wise investment of public funds, it should also be borne in mind that good tax administration consists in much more than punitive measures. In the type of self-assessed levy like the intangibles tax, taxpayer willingness to cooperate is an indispensable requirement. The public should be aware of the tax and compliance should be facilitated as much as possible. Michigan would appear to fall down rather badly in this regard.

THE ECONOMIC EFFECTS OF THE TAX

In removing intangibles from the general property tax burden states have two general alternatives: 1) they can adopt a partial or comprehensive system of classification and tax intangibles at a lower rate than other property, or 2) intangibles can be declared exempt and their income taxed under a general income tax. Michigan

follows the first of these alternatives and taxes representative property at a special low rate as compared to other property under the general property tax. Thus, the burden of double taxation on both the underlying physical asset and its representative claim is continued, but the discrimination resulting is milder.

Double taxation causes a series of specific discriminations: it discriminates against corporations and in favor of individual proprietorships; it penalizes mortgaged property as compared to unmortgaged property; it is a special burden on businesses which have a relatively high amount of accounts receivable; it restricts investors as compared to those who spend their income on consumption.

The intangibles tax may be viewed as a general burden on all the property rights or general credit and investment instruments listed as taxable in the act. Any tax is a depressant on the object on which it falls: it discourages its use or inhibits its development. More specifically, the intangibles tax increases the cost of obtaining funds and decreases investment. Although these generalizations are true in principle, they are modified in effect by the fact that the intangibles tax rate is low.

Michigan's intangibles tax is a specialized type of income tax – it singles out a particular type of income for taxation, whereas all other income in Michigan is not subject to an income tax. An attempt is being made to tax ability to pay, but only one particular manifestation of ability to pay. A general income tax, on the other hand, treats all income uniformly.

Since the income tax feature of the intangibles tax is applicable only to income producing intangibles, the economic effect is to favor investors for capital appreciation over those who invest for income. The intangibles tax is likely to be progressive as measured by income, but it does not have the equalizing effect of a progressive income tax. It should be further noted that relating the tax to income causes the tax revenue to be unstable.

Ascertaining the final burden of the intangibles tax presents a complex and largely indeterminate problem of shifting and incidence. About the only general conclusions possible are: 1) A part of the burden is in the nature of an individual income tax, and the tendency in this case is that the impact and incidence of the tax is on the same person. 2) A second part of the burden becomes a business cost, and since this cost must be covered in the long run through higher prices, the result of the higher prices is a diffusion of the burden in undermined proportion. 3) There is resistance to the shifting of the tax from the payer of the tax to the issuer or seller of securities, because of the fact that many securities are sold in a national market where price and income yields could only be affected to a minor degree by state taxation. It is clearly a liability of the intangibles tax that the incidence remains so ambiguous.

SUMMARY

A brief balance sheet of the conspicuous advantages and disadvantages of the intangibles tax is as follows:

Advantages

1. The tax introduces an element of ability to pay, as measured by income, into the Michigan tax system.
2. The moderate rates and yield do not impede investment and production in Michigan when comparison is made with other states.
3. The yield is elastic, which is an advantage, given secular inflation.
4. The tax tends to make the Michigan tax system more widely based.

Disadvantages

1. It lacks fairness because of discriminatory double taxation and the subjecting of only income from intangibles to an ad personam measure of ability to pay.
2. There is an unequal application of the tax because of evasion.
3. The yield is unstable given business cycles of some considerable magnitude.
4. The tax is not easily understood by the public.
5. The incidence of the tax is uncertain as compared to taxing the income from intangibles under a general income tax.

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