February, 1964

ANALYSIS OF H.B. 704 -- "THE CITY INCOME TAX ACT"

H.B. 704 implements Article VII, Sec. 21 of the new constitution which provides that cities and villages may levy taxes other than property taxes subject to constitutional and statutory limitations and prohibitions. H.B. 704 authorizes cities to impose a local income tax in accordance with a uniform city income tax ordinance provided in the bill and prohibits villages from levying local income taxes.

The bill provides that no city or village may impose a local income tax prior to January 1, 1965, except that those cities that had a city income tax in effect on January 1, 1964, (Detroit, Hamtramck, and Flint) may continue to levy the tax until January 1, 1965. On and after January 1, 1965, any city which wishes to impose a city income tax on a local option basis may do so only by adopting in its entirety the "Uniform City Income Tax Ordinance" provided in Sec. 6 of the bill.

It is important to note that cities and villages now have the power to impose local income taxes and in the absence of a statute prescribing a uniform tax each of the more than 500 cities and villages in Michigan could impose a different kind of income tax. A number of cities now have under consideration local income tax ordinances. H.B. 704 prohibits the almost 300 villages from levying any income tax and restricts the approximately 200 cities to levying a uniform city income tax.

Many of these cities are clustered in urban areas of the state, and if each were to design its own kind of income tax, there inevitably would be problems of double taxation, jurisdictional disputes among cities, conflicting requirements on employer withholding, differing formulas for allocating individual and business income among the taxing jurisdictions, and numerous other problems. Unrestricted and unregulated local income tax power would lead to a great diversity in local income taxation which would not be conducive to making Michigan a good place in which to live, work or do business.

The "Uniform City Income Tax Ordinance" approach provided for in H.B. 704 has a number of advantages:

- It provides a package ordinance with major rules and regulations incorporated in it which any city can adopt. This obviates the necessity for each city to draft its own ordinance covering highly technical areas of taxation and, because the ordinance is provided in state law, many of the questions of legality under a purely local ordinance are resolved.

- Every city is given equal opportunity to impose the tax on a local option basis.

- It provides uniform rates and prevents any income from being taxed in excess of one per cent.

- A common method of reciprocity is established which assures both the city of residence and the city of employment the opportunity to share in the proceeds of the tax if both impose the tax.

  A uniform method of allocating individual and business income among multiple taxing jurisdictions is established.

- The base of the tax (i.e., the kinds of income subject to tax) will be the same in all taxing jurisdictions.

  A uniform system of withholding is provided which will allow maximum collection of the tax at the source with a minimum of inconvenience to the employer who has to withhold.

  It establishes uniform reporting requirements so that individuals and businesses will submit the same kinds of reports on the same dates in multiple taxing jurisdictions.

- It provides a mechanism for resolving disputes between taxpayers and cities or among taxing jurisdictions by giving the commissioner of the state department of revenue authority to issue binding decisions upon appeal after local remedies are exhausted. It also provides for judicial review for final resolution of disputes.

H.B. 704 has six major sections. The first five sections set forth general provisions, while Sec. 6 of the Act contains the "Uniform City Income Tax Ordinance." The "Uniform City Income Tax Ordinance" is essentially a combination of the present Detroit, Hamtramck and Flint ordinances and rules and regulations (which are virtually identical) with changes made to accomodate to the problems of having multiple taxing jurisdictions and with certain other modifications based on the experience under the present ordinances. The major provisions of the "Uniform City Income Tax Ordinance" provided for in Sec. 6 of H.B. 704 and major differences between the uniform ordinance and the present city ordinances and rules and regulations are noted in the following pages.

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MAJOR PROVISIONS OF Ta "UNIFORM CITY INCOME TAX ORDINANCE"

(Sec. 6 of H.B. 704)

Sec. 2 - Definitions. The definitions in the uniform ordinance follow closely the present definitions used in the Detroit, Hamtramck, and Flint ordinances and rules and regulations. The significant changes are as follows:

Sec. 2g. This is a new definition of "doing business." The uniform ordinance provides that firms "doing business" within the city are subject to tax and are required to withhold from employees. The definition excludes firms that merely solicit orders or store property in public warehouses, if that is their only business activity in the city. The present city ordinances do not define "doing business" and are thus somewhat vague as to whom is subject to the tax and to the withholding requirements.

Sec. 2j. Defines the federal internal revenue code as "of the last day of the taxpayer's tax year," while the present ordinances fix a specific date and have to be amended each year.

Sec. 2o. A new definition of "predominant place of employment." This definition is for employer withholding purposes. Employers are required to withhold from an employee's wages in the employee's "predominant place of employment" and not in all the cities in which an employee might work.

Sec. 3 - Imposition of Tax. This section sets forth the rate of the tax (1% on corporations and resident individuals; 1/2 of 1% on nonresident individuals) and the base of the tax (the kinds of income subject to the tax).

Sec. 3b. Resident individuals will be subject to tax at 1% on all income (salaries and wages, net profits from unincorporated businesses, dividends, interest, capital gains, net rentals, income from estates, and trusts, etc.) to the same extent and on the same basis that the income is subject to tax under the federal internal revenue code. The present ordinances tax the same kinds of income, but the uniform ordinance is more closely tied into the federal code. For example, Detroit doesn't allow the federal sick pay exclusion of $100 a week. The major advantage of tying more closely to the federal tax is that the body of federal law and decisions can be used as a guide--i.e., the general rule becomes, "If its taxable for federal, it's taxable by the city and vice versa."

Sec. 3c. Non-resident individuals will be taxed at 1/2 of 1% on the following kinds of income earned in the city--salaries, wages, and other compensation, the distributive share of the net profits of unincorporated businesses, and on capital gains and net profits from rentals of real and tangible personal property located in the city. This follows the present ordinances, but is more closely tied to the federal code. Under the present ordinances non-resident individuals are taxed at the full 1% on income earned in the city instead of the 1/2 of 1% provided in the uniform ordinance.

Sec. 3d. Corporations will be taxed 1% on net profits earned in the city and net profits are defined as federal taxable income under the federal code. This follows the present ordinances.

Sec. 3e. Unincorporated entities. This follows the present ordinances. The entity is not subject to tax--the individuals or partners are taxed on the distributive share of net profits. Resident owners are taxed a full 1% on all net profits, regardless of where the profits were earned. Non-resident owners are taxed 1/2 of 1% on net profits earned in the city. The entity may pay the tax on behalf of the owners or partners.

Sec. 3f. Allocation of business profits. The uniform ordinance permits separate accounting or an allocation method, The allocation method is the 3 factor formula (property, sales and payroll) used in the B.A.T., with destination of sales being used in the sales factor. The Detroit ordinance is being amended to require capitalization of rentals of tangible personal property in the property factor (annual rental X 8). The B.A.T. and uniform ordinance do not include this factor--only real property rentals are capitalized.

The remaining provisions on allocation follow the present ordinances (which were patterned after the B.A.T.).

Sec. 3g. Capital gains and losses. The uniform ordinance follows the present city ordinances. Gains and losses subject to tax will be computed from the effective date of the ordinance (January 1, 1965, or any subsequent year) except that Detroit, Hamtramck, and Flint will continue to compute gains and losses from the effective dates of their present ordinances (July 1, 1962 in Detroit).

Sec. 3h. Estates and trusts--follows present ordinances.

Sec. 4 - Exemptions and Exclusions.

Sec. 4a. Exemptions--follows present ordinances. Each taxpayer is allowed the same personal and dependency exemptions as he is allowed under the federal code ($600 per taxpayer and dependent with extra exemptions for blind and over 65). A taxpayer is allowed the full exemption in each community in which he works--exemptions are not pro-rated. For example, if a non-resident with five exemptions earns $5,000 in City A, and $3,000 in City B, both of which impose the tax, his tax would be as follows:

Income earned in City A	$5,000
Less 5 exemptions $600 @	-3,000
Taxable income	$2,000
Tax rate 1/2 of 1%	.005
Tax due in City A	$10.00
Income earned in City B	$3,000
Less 5 exemptions $600 @	-3,000
Taxable income	- 0 -
Tax due in City B	- 0 -

If this taxpayer's city of residence also imposes the tax and he receives an additional $2,000 of income in his city of residence (total income $10,000) his tax would be as follows:

Total income	$10,000
Less 5 exemptions $600 @	-3,000
Taxable income	$ 7,000
Tax rate – 1%	.01
Tax liability in city of residence before credit	$ 70.00
Less credit for tax paid City A	-10.00
Tax due city of residence	$ 60.00

The present ordinances also provide full exemptions for non-residents employed in the city, even if they are employed in more than one city. Thus, a non-resident who works in both Detroit and Hamtramck now receives his full exemptions in each city. The uniform ordinance follows the present ordinance in this respect.

Sec. 4b. Exclusions. The exclusions in the uniform act follow closely the present ordinances with the following deviations:

(2) sickness benefits are taxable only to the extent taxable under the federal. Present ordinances tax them completely if paid by the employer (e.g., don't allow federal $100 sick pay exclusion).

(5) a new section exempting certain trusts that are exempt under federal. Detroit doesn't tax these at present, but could under the present ordinance since they are not specifically excluded.

Detroit is amending its ordinance to exclude military pay--this is not excluded in the uniform ordinance. Detroit indicates that federal law prohibits taxing military pay of non-residents.

Sec. 4c. Deductions. Follows present ordinances. Only business expense deductions are allowed for individuals. Non-business deductions (taxes, interest, medical, contributions, etc.), are not deductible.

Sec. 5 - Taxpayer Return Procedure. Follows present ordinances, except that Sec. 5a adds a new provision that an annual return is not required if the taxpayers owes less than $2.00.

Sec. 6- Collection of Tax.

Sec. 6a. Withholding.

(1) Every employer maintaining an establishment or doing business in the city is required to withhold. This follows the present ordinances, but the uniform act defines "doing business" more narrowly thin the present ordinances.

The withholding system provided for in the uniform ordinance is similar to that provided in the present ordinances with provisions added to take care of the 1/2 of 1% on non-residents and to accommodate to the likelihood of several jurisdictions taxing the same individual. Under both the present ordinances and the uniform ordinance, the employer will withhold on the basis of an employee withholding certificate signed by the employee which shows the number of exemptions, the city of residence and, in the case of a non-resident the estimated percentage of time spent or income earned in the city of employment. Under the uniform ordinance the employee will designate his predominant place of employment in addition to the items provided in the present ordinances. The employer will withhold on the basis of the information on the certificate as follows:

Sec. 6a (1)(a) Residents - 1% on all compensation unless the employee is also subject to withholding in his predominant place of employment, in which case 1/2 of l% will be withheld for the city of residence.

Sec. 6a (1) (b) Non-Residents - 1/2 of 1% on the income earned in his predominant place of employment.

Thus, an employer will be required to withhold for no more than two cities—the city of residence and the predominant place of employment.

The remaining provisions on withholding (Sec. 6a), declaration of estimated tax (Sec. 6b), and annual return (Sec. 6c) are similar to those in the present ordinances.

Sec. 64 Income Tax Paid to Another Municipality. This provision is similar to the present ordinances, but reflects the 1/2 of 1% tax on non-resident under the of uniform ordinance.

Sec. 7 - Administration - this follows the present ordinances. Sec. 7a is a new section, which provides for special rulings.

Sec. 8 - Enforcement - this provision follows the present ordinances. The appeal provisions which are under "enforcement" in the present ordinances are under Sec. 9, "Appeals" in the uniform ordinance.

Sec. 9 - Appeals. This entire section has been revised substantially from the present ordinances with respect to both the composition of the board of review and the things which may be appealed.

Sec. 9a. Board of Review. The uniform ordinance provides that the three members of the board of review cannot be officials or employees of the city, while under the Detroit ordinance the board of review consists of a member of the Common Council, a member of the board of assessors, and a member from the corporation counsel's office.

The uniform ordinance provides that the board is to hear appeals from final assessments, claims for refunds, and special rulings. The hearings on special rulings are new—there *is* no specific provision in the present ordinances for special rulings, although special rulings are in practice made.

Sec. 9b. Appeal to the Commissioner of the State Department of Revenue. This is a new provision--there is no comparable provision in the present ordinances. While the uniform ordinance incorporates provisions from both the present ordinances and rules and regulations to provide a comprehensive income tax ordinance; it also provides as do the present ordinances that the city income tax administrator IS authorized to issue rules and regulations subject to the approval of the city council. This power to issue rules and regulations (and special rulings) is necessary because the uniform ordinance cannot cover every contingency.

The power to issue local rules and regulations and special rulings, while necessary, can lead to substantial diversity among the various cities imposing the tax. Thus, on individual, business or employer working or doing business in more than one city could find that two or more cities have issued conflicting regulations. Two cities could be taxing the same income with a combined tax in excess of 1% or two cities might impose conflicting withholding requirements.

In order to resolve these conflicts, the uniform ordinance provides for appeal of rules and regulations, final assessments, and special rulings to the commissioner of the state department of revenue after local remedies have been exhausted. The commissioner could issue orders resolving such conflicts. This provides an essential mechanism for maintaining the necessary uniformity among multiple taxing jurisdictions.

Sec. 9c. This is a new provision on appeal to circuit court after exhausting administrative remedies.

Sec. 10 - Penalties. These provisions are the same as the present ordinances. However, Detroit is amending its ordinance to delete the present requirement that violations be "wilful."