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THE SINGLE BUSINESS TAX AND THE CAPITAL ACQUISITION DEDUCTION

As a result of a Michigan Court of Appeals ruling on the capital acquisition deduction under the single business tax, the State of Michigan is faced with a major revenue loss (an estimated \$450 million annually) instead of the major revenue gain (about \$500 million) it anticipated from an earlier Michigan Court of Claims ruling. In Caterpillar Corporation v Department of Treasury the Court of Claims had ruled that the capital acquisition deduction allowed under the single business tax was unconstitutional because it discriminates against interstate commerce and the Court of Claims eliminated entirely the deduction. This would have increased business tax liabilities by about \$500 million annually. The Court of Appeals, however, ruled that only the method of apportioning the capital acquisition deduction from the single business tax base was unconstitutional and that the deduction remains. The net result would be that all capital acquisitions everywhere (total investments in buildings, machinery and equipment, etc.) could be deducted without apportionment from the single business tax base after it has been apportioned to Michigan. This would about double the cost of the present capital acquisition deduction and reduce state revenues by an estimated \$450-\$500 million annually.

This analysis discusses the nature of the single business tax and the capital acquisition deduction and the alternatives that are likely to be considered.*

Single Business Tax and Capital Acquisition Deduction in Theory and Practice

The single business tax was adopted in 1975 and the name denotes the fact that it replaced with one tax a number of separate state and local taxes on business including the state corporate and financial institutions income taxes, the corporate franchise tax, the local property tax on inventories, the state property tax on utility inventories, the business intangibles tax, the domestic insurance company privilege tax and the privilege taxes on building and savings and loan associations. Excluding a first year windfall to the state, the SBT was designed to yield the same amount of revenue as the business taxes repealed or modified.

The single business tax is a modified "value added" tax on the increase in the market value of a product or service resulting from business use of labor and capital. Value added is the sum of the payments made for labor and capital or, equivalently, the difference between the amount the producer receives for the sale of the product and the amount paid for purchases from other businesses.

* The staffs of the Department of Treasury, the House Taxation Committee, the Senate Fiscal Agency, and the Senate Republican Office have prepared analyses of the issue and identified alternatives.

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There are three types of value added taxes which differ primarily in their treatment of capital investment. One type does not allow any deduction for depreciation or for, capital investments. A second type allows a deduction for depreciation. The third, the “consumption” type, allows a deduction for the cost of purchases of capital facilities. Michigan chose the “consumption” type of a value added tax.

The base of the Michigan single business tax is the sum of all compensation paid and profits interest paid and depreciation minus a deduction for capital investments, plus certain other adjustments (including a labor intensity deduction). For firms whose business activity is 100 percent in Michigan, the base of the tax is directly allocated to Michigan. For firms with multi-state activities, business activity is apportioned to Michigan by means of the traditional three factor apportionment formula -- property, payroll and sales in Michigan as a percent of all property, payroll and sales everywhere.

After the tax base is apportioned to Michigan, the capital acquisition deduction is taken. However, instead of using three factor apportionment (property, payroll and sales) that is used in apportioning the single business tax base, the deduction uses different apportionment methods. For buildings, a 100 percent deduction is allowed for investments physically located in Michigan and no deduction is allowed for investments outside Michigan. The deduction for investments in machinery and equipment is apportioned to Michigan by a two factor formula -- property and payroll in Michigan as a percent of property and payroll everywhere. This two factor apportionment of the deduction for machinery and equipment was what was specifically challenged in Caterpillar.

The Rationale for the Capital Acquisition Deduction

There are several reasons for using the “consumption” type of value added tax which allows for a deduction of capital acquisitions in the year made with annual depreciation subsequently included in the tax base. First, the capital acquisition has already been subjected to the single business tax paid by the contractor or supplier and the deduction avoids double taxation. Second, the value added by capital investments occurs over time as the capital investment is used in the production process or business activity. Deducting the cost of capital investments in the year of acquisition and including annual depreciation in the base reflects the value added each year by the use of the investment. Last, but not least, the single business tax was designed to lessen the tax burden on capital, thereby encouraging new investment. This was done by repealing the prior taxes on business capital (income, franchise, intangibles and inventory property taxes) and by providing for a capital acquisition deduction in the year investments were made.

The capital acquisition deduction and the method of apportioning it to Michigan are designed to encourage business investment within Michigan. In the February 19, 1991, decision in the Trinova v Michigan Department of Treasury, the U.S. Supreme Court noted that:

In further support of its discrimination argument, Trinova relies upon the 1987 statement of Michigan’s Governor that the SBT was enacted ‘to promote the development and investment of business in Michigan.’ This statement helps Trinova not at all. It is a laudatory goal in the design of a tax system to promote investment that will provide for jobs and prosperity to the citizens of the taxing state. States are free to structure their tax systems to encourage the growth and development of intrastate commerce and industry.

The Rationale for the Method of Apportioning the Deduction

The capital acquisition deduction is subtracted from the single business tax base after the base has been apportioned to Michigan by three factor apportionment. As previously noted, instead of using three factor apportionment of capital investments, the deduction provides that investment in buildings can be deducted 100 percent for buildings physically located in Michigan and investments in machinery and equipment are apportioned to Michigan by two factors--property and payroll--and exclude the sales factor.

In the Caterpillar case, the Michigan Court of Claims stated: "This Court holds that the Capital Acquisition Deduction (CAD), of the Michigan Single Business Tax Act, is unconstitutional on grounds that it violates the Commerce Clause (United States Constitution, Article 1, Section 8, Clause 3)." The Court of Claims found that the deduction discriminates against business with large out-of-state operations and that the deduction operates to favor businesses with all or most of their operations in Michigan. The net effect of the Court of Claims ruling was to throw out the entire deduction which would have increased single business taxes by about \$500 million, a 28 percent increase.

In hearing the appeal from the Court of Claims decision, the Court of Appeals noted that the state did not appeal the Court of Claims ruling that the capital acquisition deduction violated the Commerce Clause of the U.S. Constitution. The Court of Appeals, however, did not invalidate the entire statutory provision for the deduction, but only the portions apportioning or allocating to Michigan the deductions from the single business tax base that offend the Commerce Clause. This means that all capital investments everywhere could be deducted without apportionment from the base of the single business tax that has already been apportioned to Michigan. This increase in the deduction would eliminate the tax liability of many out-of-state firms and some Michigan based firms. This would reduce the single business tax yield by about \$450 million, a 25 percent reduction.

Where Does Michigan Go From Here

Clearly, a legislative solution is in order. A number of alternative solutions to the problems resulting from the Caterpillar decisions have been discussed. These range from eliminating the deduction (per the Court of Claims decision), which would increase business taxes and state revenues, to increasing the capital acquisition deduction (per the Court of Appeals decision), which would decrease state business taxes and state revenues. In between are a number of proposals which would neither significantly increase nor decrease business taxes or state revenues. The staffs of the treasury department, the house of representatives and the senate have prepared a number of alternatives that might be considered. These include:

1. Retain the capital acquisition deduction but apportion capital investment to Michigan by the three factor formula currently used to apportion the base of the single business tax which has just been upheld by the U.S. Supreme Court.
2. Retain the deduction but apportion both the deduction and the base of the tax to Michigan by a four factor formula (property, payroll and sales and sales) which double weights the sales factor.
3. Eliminate the deduction and eliminate the add-back of depreciation to the tax base so that capital investment is not double taxed.

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4. Eliminate the deduction and reduce the tax rate.
5. Eliminate the deduction and provide for an investment tax credit for new investment in Michigan. A number of states have direct (unapportioned) investment credits.
6. Eliminate the capital acquisition deduction, but provide a credit against the single business tax for a portion of business property taxes.
7. Eliminate the deduction but begin phasing out the property tax on tangible personal property.

In evaluating these alternatives several factors need to be considered. First, any change in the present deduction will cause shifts in tax impacts between Michigan based and out-of-state firms. Second, tax impacts will also shift among types of businesses (manufacturing, retail, utilities, etc.). Third, there will be shifts in tax impacts among individual firms. There will be winners and losers in even a revenue neutral change from the present deduction. Finally, consideration must be given to the fact that Michigan business taxes are already high in relation to other states and that both the state and many of its businesses are currently facing serious financial problems.

In evaluating the alternatives to the present capital acquisition deduction, consideration should be given to the original purpose of the deduction. As stated by the U.S. Supreme Court in the Trinova case, “It is a laudatory goal in the design of a tax system to promote investment that will provide for jobs and prosperity to the citizens of the taxing state.”

The current overall level of taxes on capital investment in Michigan are relatively high. The U.S. Advisory Commission on Intergovernmental Relations calculates relative tax capacity and tax effort for the 50 states. It reports that Michigan state and local taxes on “corporate net income and net worth, which includes the single business tax, were 78 percent higher than the U.S. average in 1988, second highest among the 50 states. Property taxes in Michigan were 57 percent above the U.S. average, also second highest among the 50 states. Total state and local taxes in Michigan were 12 percent above the U.S. average.