FY 2020 Executive Budget Recommendation

**Department of Treasury**

# Pass-Through Tax Parity

March 5, 2019

## Summary

This recommendation increases the tax on certain business income earned in Michigan and provides a revenue source to support repeal of the tax on retirement benefits. Currently, certain business income from partnerships, LLCs, and S-Corporations is taxed at a lower rate than traditional corporations. This proposal will apply rate parity to these pass-through entities by taxing their business income at the same 6-percent rate that applies to corporate income tax filers.

## Background

Before 2011 tax changes, business income from partnerships, LLCs, and all corporations were taxed at the same rate. In 2011, the law was changed and only income earned by traditional corporations in Michigan is now subject to an income tax at 6 percent. Income earned by partnerships, LLCs, and S-Corporations, many of which operate in a similar manner to traditional corporations, passes through to the owners for tax purposes and is taxed at the individual rate of 4.25 percent. This proposal will create a new 6 percent income tax on partnerships, LLCs, and S-Corporations, the same as the corporate income tax rate. The proposal includes an individual income tax credit for owners of these businesses to avoid double taxation and effectively create a 1.75 percent increase in the state tax rate on this income.

The 2011 changes resulted in a business tax cut of more than $1.5 billion, paid for by a tax increase of more than $1.5 billion to individual taxpayers, which included the increased taxation of retirement and pension benefits. The Governor's proposal reverses part of the business tax cut and provides a tax cut to retirees.

## Tax Offsets

While the vast amount of pass-through income is reported on high-income tax returns, this proposal adds protection for small businesses with a $50,000 deduction. Pass-through entities with less than $50,000 in income will not pay any additional tax. Individual owners of pass-through entities will claim a credit on their individual income tax return to avoid double taxation on their share of the business income. Proprietors, who report business income on federal Schedule C or F, are not subject to the new tax.

While this tax will raise an estimated $280 million by FY 2021, the cost to Michigan business owners will be much less because the entity tax will be deductible for federal tax purposes, providing Michigan business owners with new federal tax deductions. These deductions will reduce the combined net federal and state cost of this tax to $100 million or less. This will allow for repeal of the retirement tax at a greatly reduced cost and keep more tax dollars in Michigan.

## Budget Impact

The revenue impact from the Pass-Through Tax in FY 2020 will be approximately $203 million, rising to $280 million in FY 2021. These additional revenues will offset most of the cost of repealing the retirement tax.