Anderson Economic Group Tax Note: Likely Effect of Michigan Prop 2015-1 ("Road Tax" Proposal on May 2015 Ballot) on Federal Income Taxes

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Summary

The legislature and governor proposed in late December 2014, a constitutional amendment that will be put before Michigan's voters on May 5th, 2015. Proposal 2015-1 would amend the constitution and trigger a package of related bills that would raise funds for road construction and maintenance, K-12 education and community colleges, and local governments, while restructuring several taxes.

Although described loosely as a "road tax" proposal, the effects of the proposal are far reaching, and complicated. Among these is a change in the amount and the type of registration tax levied on personal cars and other vehicles. This not only affects state tax revenue, it also raises federal tax liabilities for over one million Michigan residents. This occurs because many Michigan taxpayers will no longer be able to claim a tax deduction they currently claim. In its current form, the vehicle registration tax is a deductible personal property tax under the Internal Revenue Code. Our analysis of the new tax indicates that it would no longer meet the criteria set out in federal law for deductible taxes of this type.

We summarize a preliminary estimate of the effect of this loss of deductibility beginning in the year 2018 in this *Tax Note*. The key assumptions and calculations are as follows:

- Over 1.2 million Michigan residents itemized their deductions and claimed a deduction for property taxes, for tax year 2012. The property tax deduction was more popular than the mortgage interest and charitable deductions (both about 1.1 million claimants). Because many residents file as part of a household, this represents at least three million Michigan residents. The total deduction claimed for real and personal property taxes exceeded $4.3 billion.
- Registration taxes collected by the State of Michigan exceeded $768 million in 2013 (including registration plate fees for passenger vehicles, plus vehicle registration fees paid at purchase). There were 7.4 million passenger vehicles registered in 2013.
- We estimated the effect of a loss of deductibility using an apportionment of the property tax claimed in 2012; projecting that amount forward to 2018; and taking into account such factors as the alternative minimum tax (AMT) and the progressive rate structure of the federal income tax.
- Using this approach, we estimate that Michigan residents who itemize their deductions would lose the benefit of approximately $410 million in itemized deductions. This would result in them paying approximately $102 million in additional federal income taxes, if the proposal is adopted and other state and federal tax laws remain the same.

There are obvious limitations and cautions to our analysis, including the fact that this exercise requires the projection of *both* state and federal income tax laws into the future; *and* the underlying vehicle purchasing and ownership behavior of Michigan residents; *and* the likely changes in income over time; as well as the interaction of these with the progressive structure of U.S. income taxes. Furthermore, it is likely that federal tax laws, and state tax laws, will change between now and the time period we estimated. Our analysis is preliminary and based only on the data now available; we may revise it in the future.

In addition to these general limitations, we identify specific risks to Michigan taxpayers regarding the new tax. We recommend that taxpayers consult with their own legal counsel regarding these risks and their personal tax situation.

Deductibility of Certain State & Local Property Taxes against Federal Income Taxes

State and local property taxes can be deducted in arriving at taxable income for those who "itemize" their deductions. This includes personal property taxes. Both the authority to deduct, and the definition of personal property taxes are explicit in the Internal Revenue Code:

> *Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) State and local, and foreign, real property taxes. (2) State and local personal property taxes.*
>
> *...*
>
> *For the purposes of this section:*
>
> *(1) Personal property taxes: The term "personal property tax" means an ad valorem tax which is imposed on an annual basis in respect of personal property.*
>
> [26 USC sec 164]

This instruction is further repeated in IRS publication 503, which lists "personal property taxes" as a deductible non-business tax. This same publication also lists categories of taxes that are *non-deductible,* including local benefit taxes such as special assessments, and warns taxpayers against deducting them.

Proposal 2015-1 and Changes to the Michigan Vehicle Registration Tax

Voter adoption of Proposal 2015-1 would trigger the effect of a set of statutes, including one that would change the current vehicle registration tax. The current statute levies a 0.5% tax on a base that declines over time. This is not exactly an ad valorem tax, but mimics one for at least several years. The new statute would levy a straightforward excise tax on the list price of the vehicle. The levy would be repeated annually without regard to the current value of the vehicle or its age.

This is clearly not a deductible ad valorem personal property tax under the Internal Revenue Code.

Risks to Taxpayers

Of course, this is our interpretation of the Internal Revenue Code with regard to a just-enacted law that has not, and may not, go into effect. If it does go into effect, taxpayers may face an awkward choice: continue deducting a tax that no longer technically fulfills the requirement, hoping the IRS will allow it; or choose not to deduct it and pay additional federal taxes. Those taking the former approach, of course, risk not only the cost of the repaying multiple years of disallowed deductions, but also penalties, interest, and interest on penalties.

Some taxpayers may hope that the IRS will just ignore the new law, or treat it as a minor adjustment in the state's taxing formula. However, the change from an ad valorem tax to an excise tax was done in the open. For example, the House Fiscal Agency description of the bill that resulted in that statute states:

> *House Bill 4630 would implement increases in certain truck registration fees and increase vehicle registration tax revenue through eliminating the "depreciation" of ad valorem tax rates for passenger cars, vans, and light trucks.*
>
> [HFA analysis of Transportation Funding Package, December 2014]

The explicit and public description of the new law at the time of adoption makes it unlikely, in our opinion, that the IRS would simply treat the new tax the same as the old tax.

Michigan Taxpayers and Itemized Deductions for Personal Property Tax

In Michigan, 29% of federal income tax filers itemized in 2012. Over 90% of whom (26.6% of taxpayers) claimed an itemized deduction for state & local property taxes, according to IRS data analyzed by AEG. The average deduction was around $950.

Separate data indicate that, in a typical year, among taxpayers with $20,000 to $50,000 in gross income, about a quarter itemize their deductions; for those with income between $50 to 100,000, the share jumps to over half; and for those with income over $100,000, 90% itemize. The definition of "income" used in these calculations includes all salary, wages, interest, and other income for an entire taxpaying household. Thus, many taxpayers whose wages are below $50,000 per year actually file taxes as a household with "adjusted gross income" of over $100,000.

Estimating the possible loss of benefit from disallowed property tax deductions in Michigan, however, is quite complicated. Among other confusing factors, the AMT recaptures some share of itemized deductions; and in many years tax laws phase out the benefit of deductions to high-earning taxpayers. Furthermore, IRS source data lump together types of state & local taxes.

Anderson Economic Group Estimation Method

In this case, AEG estimated the potential loss using the following method: projecting forward from 2012 data the earnings, expenditures, and tax rates expected in 2018; changing the character of the Michigan auto registration tax from an ad valorem tax to an excise tax; and estimating the portion of registration taxes that are paid by those who itemize.

With these data, we created a simplified model of federal liabilities, and took into account the relative size of various tax deductions and their interaction, as well as the effect of the AMT. As a check on our analysis, we also created a representative household calculation that could be generalized to all Michigan residents. These two methods give similar results.

About Anderson Economic Group

Anderson Economic Group is an economic research and consulting firm with offices in Michigan and Illinois. Their work has resulted in multiple public policy improvements for the State of Michigan including a change in the sales tax law (1998); reform of the tax reversion process (1999); creation of the industrial personal property tax credit (2005); the repeal of the SBT (2006); a wage increase for home help workers (2006); creation of the Michigan earned income tax credit (2008); and repeal of the item pricing law (2011).