

Riley Administration Prepares To Offer Tax Reform and Education Accountability Package

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This newsletter is designed to discuss recent state and local tax developments and was prepared by our firm's SALT Practice Group. It should not be construed as providing legal advice or legal opinions on any specific fact situation. Comments and suggestions are welcomed and may be forwarded to any member of the SALT Practice Group.

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At the request of Governor Bob Riley, the 2003 regular session of the Alabama Legislature was suspended yesterday afternoon in anticipation of his call for a special session, to begin Monday at 6 pm with a televised speech from the Governor's office, and dealing primarily with the Administration's tax reform and education accountability legislative package. The package is designed primarily to plug what has now become an estimated \$675 million deficit for the fiscal year beginning October 1, but several sources score the package as raising possibly \$1.2 billion or more. This SALT Bulletin will provide an overview of the current proposals as we understand them, with the expectation that the final version of the 23 or more bills—not yet released—will likely vary somewhat from the summaries provided and presentations made to various legislators, lobbyists, and the press over the past two days. The official bills may not be introduced until Monday afternoon but committee hearings will begin Tuesday. The session will adjourn no later than June 6.

1. Corporate income tax.—The package would offer a constitutional amendment to repeal the corporate deduction for federal income taxes, which presently generates approximately \$70 million in revenue. Financial institutions—currently subject to a separate 6.5% financial institution excise tax—would become subject to the corporate income tax and would lose certain benefits afforded them under the FIET. It is uncertain whether the current nexus consolidated return filing privilege will be retained. The package likely will include so-called technical corrections to the controversial "anti-PIC" or "royalty/interest expense add-back" legislation enacted in December 2001. It is possible that the corporate income tax rate might drop from 6.5% to 6%, to reflect the simultaneous repeal of the federal income tax deduction.

2. Individual income tax.—As expected, the package would substantially increase the filing threshold for low income taxpayers, which the Governor has long championed, along with the Campaign for Alabama, Alabama Arise, and various religious denominations. For example, the current filing threshold of \$4,600 for a family of four would increase to approximately \$17,000, then over time to approximately \$20,000, but that benefit would phase out for high income taxpayers. Graduated tax rates ranging from 4% to 6% would be introduced. The "constitutionalized" deduction for federal income taxes would be repealed for individuals as well, generating over \$340 million in new revenue alone.

3. Intangibles tax.—The package will include a one mill ad valorem tax on certain intangibles, with an exemption of the first \$200,000 in value and with a cap of \$5,000. That has been a sticking point in many efforts to increase ad valorem taxes on real estate—that there should be more of a level playing field between the two assets. Readers may recall that attempts to pass an intangibles tax in the early 1990's failed.

4. Real and personal property ad valorem tax.—The second major element of the Administration's tax reform package are several major adjustments to Alabama's system of taxing real and tangible personal property, with the revenue estimate for these provisions in the range of \$435 million, initially. Historically, Alabama has been ranked as the state with the lowest average property tax in the U.S. Currently, taxable property is divided into four classes by the Alabama Constitution: Class I—utility property; Class II—commercial/business property; Class III—agricultural/timber/residential (single family, owner-occupied) property; and Class IV—personal automobiles/trucks. The assessment ratios range from 30% for Class I down to 10% for Class III and 15% for Class IV assets, with Class III (agricultural/timber and most residential property) then subject to so-called "current use" valuation limitations.

First and foremost, the various assessment ratios for state property taxes would be abolished and all taxable property would be assessed at 100% of its value, primarily using comparable sales as the valuation method. In return, the current state millage rate of 6.5 mills would decrease to 3.5 mills. Through a complicated formula, however, the assessment ratio for utility property would be frozen at current levels for existing property and only later-acquired property would become subject to a lower effective ratio of 22%. We understand, however, that the utility valuation methodology is still being fine-tuned. Readers may recall that the Alabama Department of Revenue recently began implementing an annual revaluation program throughout the state that is estimated to generate another \$155 million in new revenues over time.

Local (county, municipal and school district) ad valorem taxes would remain essentially the same except that the millage rate for Class I property would reportedly phase-in an effective assessment ratio of 22%. Again, annual revaluations will also likely cause the owner's property tax bill to increase over time. The homestead exemption would increase from \$4,000 (generally) of assessed value to \$50,000 of fair market value. Thus, the owners of a \$50,000 home would owe no state property tax.

5. Sales/use taxes.—It is unlikely that the pending Streamlined Sales Tax legislation, HB 649, will be debated during the special session due to ongoing negotiations between the ADOR and the local governments. However, the state-level sales/use tax on automobiles and trucks would increase from 2% to 3%, and the rental tax on these vehicles would also increase correspondingly. It is uncertain what effect, if any, the proposed legislation would have on local sales/use tax rates. Additionally, a 4% state sales tax would be imposed on certain services such as repair and installation in connection with the sale of tangible personal property, such as auto repairs or the installation of a new air conditioning unit. These changes are estimated to generate approximately \$100 million annually.

6. Tobacco/alcohol excise taxes.—Also as expected, the excise tax on cigarettes and alcoholic beverages would increase substantially, generating approximately \$70 million annually. For example, the cigarette tax would increase by 25 cents per pack. Alabama currently has one of the lowest cigarette taxes in the country.

7. Real property transfer/mortgage taxes.—Although the parameters of this tax proposal are still sketchy, the package would substantially increase the recording fees on the sale of real property and the filing of mortgages. We understand that the fees would essentially double, generating approximately \$50 million annually.

8. Earmarking.—One issue that has concerned Governor Riley from the outset is the incredible amount of earmarking of state revenues, in the range of 92%. Alabama ranks first on the

earmarking scale and no other state is even a close second. All new revenues derived from the tax package, if enacted and approved in its present form, would be unearmarked.

Accountability and Education Improvement Proposals

Another crucial part of the Administration's legislative package is comprised of several bills dealing with education accountability, reforms to the quite favorable public school health insurance plan, expansion of reading and pre-kindergarten programs, and even funding for college scholarships for qualifying in-state residents, similar to Georgia's HOPE scholarship program.

An issue that concerns many business taxpayers with skyrocketing health insurance costs has been the extremely low health insurance premium paid by public school employees under the so-called PEEHIP. For example, a teacher pays only \$2 a month for single coverage and only \$134 for family coverage, and with a quite generous insurance plan in terms of benefits and co-pays. Those premium charges would increase substantially over time, but are tied to expected pay raises.

School administrators would lose their tenure protection and teacher tenure and presumably termination disputes would be submitted to binding arbitration rather than drawn out court proceedings. The Superintendent of the State Board of Education would be granted the right to replace a local school superintendent in certain defined circumstances. On the other hand, the minimum retirement age and length of service requirements for new educators and state employees would be extended.

The accountability package is still being refined. However, it is clear that the reform package will be linked, so that legislators, and subsequently Alabama voters, will be asked to vote on the bills as an all-or-nothing package. Some observers have remarked that doing so is quite risky but the Governor has stated on several occasions that the voters must be assured that they will "not pay more for the same system." If the package passes the Alabama Legislature, then the statewide referendum would be held in early September.

In the meantime, the state budgets for fiscal 2004 apparently will not be finalized, pending the outcome of the referendum. Legislators expect to be called back into session during September to vote on the budgets, and on some sort of emergency or short-term tax package if the referendum fails.

Please contact us if we can assist you or your clients in reviewing and analyzing the potential impact of these bills on your or their businesses.

For more information about our law firm or any of its members, please visit our website: www.bradleyarant.com.