

Riley Administration Pushes Tax Reform and Accountability Bills

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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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On Monday, May 19, Governor Bob Riley requested that the Legislature suspend its regular session and begin a special session focused on tax reform and educational accountability. The Legislature did so and the Governor's 23 bills were introduced that same afternoon. The bills are designed to plug what has now become an estimated \$675 million deficit, inherited by Riley from prior administrations, for the fiscal year beginning October 1. However, in an effort to end the state's fiscal crisis once and for all, several sources score the package as raising possibly \$1.2 billion. According to the Governor's office, if new revenues are not raised the consequences of slashing government services by \$675 million include: (1) laying off thousands of teachers and educational support staff; (2) closing 60 senior centers, which would eliminate 800,000 meals for the elderly per year; (3) losing up to \$50 million in child support payments (likely due to reduced DHR services); and (4) reducing State Trooper manpower by one-third including no State Troopers patrolling Alabama's highways after midnight.

The bills have been proposed as an "all or nothing" package. Each bill is tied to the other, along with a constitutional amendment, and each would generally be effective for tax years beginning on or after January 1, 2004. Under the Governor's current proposal, all the bills must pass and the related constitutional amendment must receive a favorable vote of the people in order for the proposals to take effect. In a conference call yesterday with members of the Business Council of Alabama, the governor promised a "level of accountability never seen in Alabama" and "that new money (raised by the proposals) will fund initiatives for new programs that will begin to transform this state." He also said the "last thing I want to do is become an obstacle to anyone's success," stressing that none of the proposed taxes will place Alabama businesses at a disadvantage compared with other businesses in southeast.

Five of the Governor's bills, House Bills 2 (cigarette tax), 4 (utilities gross receipts tax), 7 (deed/mortgage tax), 13 (insurance premium tax credits), and 22 (intangibles tax) were approved by the House yesterday and have been sent to the Senate. The income tax and ad valorem tax bills have been tied up in negotiations between various groups but are slated for House committee review today. As of last night, the income tax bill had over 35 proposed amendments. The special session is currently slated to end by June 6.

This SALT Bulletin will provide an overview of the significant proposals by bill number, as introduced last week, with the expectation that the final version of the 23 or so bills will likely vary somewhat from the summaries below provided.

1. **House Bills 1 & 3 – Income and Ad Valorem Taxes.** House Bill 1 embodies the provisions that would enact certain changes to the income tax and state ad valorem tax through a constitutional referendum. The state ad valorem tax rate would be reduced from 6.5 to 3.5 mills. All state ad valorem assessment ratios would be increased to 100% effective October 1, 2003, while the local assessment ratio for Class II commercial and business property for county and municipal purposes would increase from 20% to 22% of fair market value. Utilities would transition over several years from an assessment ratio of 30% to 22% based on comparing the assessed value of their properties as of October 1, 2001, with the values derived under the new assessment. Effective for tax years beginning on or after January 1, 2004, the individual income tax rate maximum is raised from 5% to 6%. Corporate rates are changed from the current 6.5% to a rate not to exceed 6.5%. The federal income tax deduction required currently by the Alabama Constitution is repealed (but see HB 19 below for corporations).

House Bill 3 is the bill that would partly implement House Bill 1. It makes several changes in current use rules, Class II commercial, Class III agricultural, forest and residential and Class IV autos and trucks ad valorem classes and the assessment ratio is increased to 100%, phased in through 2006. The state homestead exemption is increased from \$40,000 to \$50,000 of assessed value by 2006. The county homestead exemption is not increased. "Farmsteads" are created to exempt the first 200 acres of farmland from state ad valorem taxes. A companion bill, dubbed "Starkey IV", would require each county to levy a minimum of 20 mills of ad valorem tax by a delayed effective date. Additionally, limited home rule would be permitted, bypassing the local legislative delegation in return for approval by local county voters.

2. **House Bill 2 - Cigarette Tax**. The tax on cigarettes would increase from 8.25 mills to 15.5 mills on each cigarette. This equates to about 31 cents per pack.

3. **House Bill 4 - Utility Gross Receipts Tax ("UGRT")**. This bill would repeal provisions imposing taxes of 2.2% to 2.5% on the gross receipts of railroads, utilities, pipeline companies, and express companies. The existing 4% UGRT is increased to 5.75% for customers with monthly utility bills of \$40,000 or less. The 5.75% UGRT is required by the statute to be passed through to consumers. The existing and proposed UGRT both impose lower rates on customers whose monthly utility bills exceed \$40,000. The bill has been scored as revenue neutral.

4. **House Bill 7 - Mortgage and Recording Taxes**. This bill increases the mortgage tax from fifty cents per \$500.00 of value to \$1.00 per \$500.00 of value. It increases the tax on recording deeds, contracts of conditional sale, and UCC financing statements with county probate courts from fifteen cents per \$100.00 of value to thirty cents per \$100.00 of value. This tax does not affect UCC financing statements filed with the Secretary of State. It is only due on filings with county probate judges.

5. **House Bill 11 - Sales, Use, and Rental Taxes**. Notwithstanding the recent Streamlined Sales Tax bill introduced in the 2003 regular session, the Governor has also introduced a bill that would affect certain sales, use, and rental taxes. The bill would raise the rental tax rate for leasing any automotive vehicle, truck trailer, semi-trailer, or house trailer from 1.5% to 3%. The bill would increase the sales and use tax rate levied on the sale of automotive vehicles, truck trailers, semi-trailer, house trailers, and mobile home set-up materials from 2% to 2.5%. The bill would also increase the sales tax rate applicable to vending machine sales of food and beverages from 3% to 4%. The initial version of the bill imposed a 4% sales and use tax on certain services, including repair, installation, and fabrication services. This provision has been narrowed and clarified twice in committee and is subject to more negotiation as this Bulletin is issued. In addition, the sales tax levied on sales of titled vehicles such as automotive

vehicles, motor boats, truck trailers, trailers, semi-trailers or travel trailers, purchased from a person who is not a licensed dealer, is increased from 2% to 2.5%.

8. **House Bill 13 - Insurance Premium Tax**. This bill would limit the insurance premium tax credits for Alabama office facilities and Alabama real estate investments currently enjoyed by certain in-state insurance companies so that the premium tax is not reduced below 2% of taxable premium income. The bill would also reduce the credit for business privilege taxes paid by insurance companies from 60% to 30%.

9. **House Bill 14 - Business Privilege Tax ("BPT")**. The general cap of \$15,000 on the BPT is maintained. The BPT cap for financial institutions is reduced from \$3,000,000 to \$15,000 by eliminating the ambiguous "financial institutions group" ("FIG") tax. Insurance companies and REITs would be the only two taxpayers for whom the BPT is not capped at \$15,000, with their caps remaining at \$3,000,000 and \$500,000, respectively. The deduction for 30% of pro forma taxable income of an S corporation and of a limited liability entity or disregarded entity was initially repealed but has been re-inserted by committee amendment. Filing and payment of the BPT would be required at the same time that the Alabama corporate income tax payments and returns are due. This bill is also the subject of further negotiations.

9. **House Bill 19 - Income Tax Changes**. By far, the most comprehensive and sweeping changes come in House Bill 19, which deals with income tax reform. The related constitutional amendments for House Bill 19, that deal with tax rates and the repeal of the federal income tax deduction, are included in House Bill 1 discussed above. Below is a summary of the pertinent provisions of House Bill 19:

- a. For taxable year 2003, a taxpayer is only permitted to deduct 75% of the federal income taxes paid or accrued during the taxable year. For taxable years after December 31, 2003, there is no deduction for federal income taxes paid or accrued by individuals, and only 25% for corporate taxpayers.
- b. For tax years commencing after 2003, any references to the Internal Revenue Code are to the Code in effect as of December 31, 2002, i.e., a "static" reference, although that proposal is the subject of intense negotiations.
- c. In determining an individual taxpayer's Alabama taxable income, the starting point is adjusted gross income under I.R.C. section 62, with certain adjustments.
- d. Tax rates for individuals, trusts and estates are graduated between 5% and 6%. The maximum rate for corporations remains at 6.5%.

- e. For individuals and corporations, net operating losses incurred after December 31, 2003, may not be carried back to any tax year beginning prior to January 1, 2004 and they can only be carried forward until the earlier of the full deduction or 15 years have elapsed since the net operating loss was created.
 - f. Resident taxpayers are allowed a credit against Alabama income taxes for any net income taxes paid to other states, including taxes paid on income received from ownership in a pass-through entity. Nonresident taxpayers having income taxable in Alabama and in another state are required to allocate and apportion the income pursuant to the Multistate Tax Compact.
 - g. The bill continues to allow composite returns for pass-through entities in a somewhat modified form. The rates would be determined at the highest marginal Alabama income tax rate. The major issue here involves whether the contingent liability imposed on "Subchapter K entities" (LLCs and partnerships) for delinquent nonresident partners/members should be extended to other forms of pass-through entities. Business and tax professional groups resist that effort while the Alabama Department of Revenue ("ADOR") supports it.
 - h. IRC Subchapter J conformity for taxation of trusts and estates would generally be adopted, with a few adjustments.
 - i. Certain items would not be allowed in computing a corporate net operating loss: (1) subtractions from federal taxable income allowed by Alabama Code section 40-18-35(a); (2) any dividend received deduction; (3) any deduction allowed corporations for federal income taxes; and (4) nonbusiness income shall be deductible only to the extent the gross income allocated and apportioned to Alabama exceeds the deductions allocated and apportioned to Alabama. Several of these changes may be dropped as part of ongoing negotiations.
 - j. Corporations would be required to pay state estimated income taxes in accordance with IRC section 6655, with a few modifications, including a decrease in the current filing threshold of \$5,000 of taxable income to \$500.
 - k. S corporations would be taxed on their IRC sections 1374 (built in gains) and 1375 (excessive E&P) items, as under current law, in an amount equal to the amount of such tax determined for federal income tax purposes allocated and apportioned to Alabama multiplied by 18.57%.
 - l. The bill would also make changes to the Multistate Tax Compact definition of "sales." The definition would be narrowed with respect to sales, exchanges or redemptions of various investment assets. A previously uncodified expansion of the "business income" definition, enacted in December 2001, is codified in the Alabama MTC provisions.
 - m. Financial institutions would remain subject to the separate financial institution excise tax rather than becoming subject to the corporate income tax as originally proposed.
 - n. Dividends, interest, royalties, and capital gains from sales of intangible property apportioned to Alabama would be based upon the average of the property and payroll factors in Alabama over the total factors for the taxpayer, codifying an existing ADOR rule.
10. **House Bill 22 – Ad Valorem Tax on Intangible Property.** Currently, Alabama does not impose a tax on intangibles. This bill would impose a 1 mill tax on their value and would only apply to individuals. The first \$200,000 of intangibles is exempt, with a cap of \$5,000. The tax is imposed specifically on stocks (including closely held corporations), interests in limited liability entities, notes, bonds, CDs, bank accounts, patents, copyrights, franchises, options and futures. Cash, checking accounts, demand deposits, U.S. treasury bonds, Alabama municipal bonds, retirement plans, life insurance, and annuity policies are exempt. Each taxpayer would be required to file a detailed description of intangible property and its values with its income tax return. Corporations and limited liability entities must give their owners annual notice of the value of their ownership interests (although it is uncertain as to who makes the final decision on valuation) and file a copy of this notice with the ADOR. The fair market value of closely-held stock or ownership interests in limited liability entities is presumed to be their book value but that presumption is rebuttable by the ADOR.
- 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. We are involved in negotiations over several of these bills.
- For more information about our law firm or any of its members, please visit our website: www.bradleyarant.com