



Are Alabama Businesses Paying Their “Fair Share” of Taxes?

Contact information for the State and Local Tax Practice Group at Bradley Arant Rose & White LLP:

Russell M. Cunningham, IV
(205) 521-8285
rcunningham@bradleyarant.com

Bruce P. Ely, Chairman
(205) 521-8366
bely@bradleyarant.com

Stuart J. Frentz
(205) 521-8216
sfrentz@bradleyarant.com

W. Stanley Gregory
(334) 956-7604
sgregory@bradleyarant.com

Christopher R. Grissom
(205) 521-8514
cgrissom@bradleyarant.com

K. Wood Herren
(205) 521-8505
wherren@bradleyarant.com

Scott E. Ludwig
(256) 517-5149
sludwig@bradleyarant.com

Robert D. Thorington
(334) 956-7609
rthorington@bradleyarant.com

Robert C. Walthall
(205) 521-8308
rwalthall@bradleyarant.com

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.

Disclaimer and Copyright Information. The Alabama State Bar requires the following disclosure: "No representation is made that the quality of the legal services to be performed is greater than the quality of legal services performed by other lawyers."

©May 7, 2004. Bradley Arant Rose & White LLP.

With recent budget shortfalls in Alabama, the business community has become the target of several attack ads in the local news media, alleging that many businesses don't pay their "fair share" of the total tax burden required to effectively operate the State of Alabama and provide necessary services to the citizenry. Two new studies, one conducted by the 570-member Council On State Taxation (COST), headquartered in Washington, D.C., and the other by the Public Affairs Research Council of Alabama (PARCA), headquartered at Samford University in Birmingham, should be required reading for every Alabama tax practitioner, policymaker and editorial writer.

The COST study, entitled "50-State Study of the Taxes Paid by Business in FY 2003," was released in January. A component of that study focused on Alabama business taxes and yielded some results that may surprise some, while confirming the thinking of many others. The study found that:

- (1) Alabama's state and local business taxes totaled \$4.4 billion last fiscal year (not including at least one tax, as discussed below).
- (2) Alabama's corporate income tax burden grew by 57% from 2000 to 2003, despite the dramatic increase in the use of pass-through business entities, which do not pay state corporate income tax.
- (3) Alabama's corporate income tax burden was second highest in the Southeast, with only Mississippi imposing a heavier burden.
- (4) Alabama's business excise and gross receipts tax burden was nearly double the national average, and 60% higher than the Southeastern average.

The latest Alabama Department of Revenue "Revenue Abstract" confirms points (2) and (3). Corporate income tax revenues for the six month period October 2003 through March 2004 were up almost 40% from the same period last fiscal year. Total CIT collections for October 2003 through March 2004 were \$137,328,238 as opposed to \$98,527,423 for the same period last fiscal year. Collections from banks and other financial institutions, which are taxed under the separate financial institution excise tax, were up almost 78% over the same period last year.

The overarching conclusion reached by the COST study, and a point implicit in the PARCA analysis, is that a state's business tax burden cannot be calculated by reference to only one tax, such as the corporate income tax. Instead, a comprehensive review is required, and no one industry or segment of the economy should be singled out for punitive taxation in an effort to find the needed revenue.

That is also the position of two leading statewide business organizations: the 31-member Business Associations' Tax Coalition (BATC) and the 5,000 member Business Council of Alabama, based on their 2004 legislative agendas. See www.bcatoday.org. After the demise of Amendment One, both groups (to their credit) reiterated that they remain open to discussion involving comprehensive tax reform including tax increases. But their members insist, as a condition to re-opening the discussion, that several budget and accountability reform bills advocated by Governor Riley and BATC first be enacted. It appears that very few, if any, of those proposals will pass during this legislative session.

The COST study also cautioned state legislators and other policymakers to consider the impact on a state's economy and its industrial recruiting efforts when targeting businesses for new taxes. That would be particularly true for Alabama since the state, unfortunately, was one of the first to be hit hard by the economic downturn, and only now seems to be recovering. According to the Alabama Department of Industrial Relations, the state's manufacturing sector has lost almost 58,000 jobs since 2000, including 9,900 net manufacturing jobs lost during the 12-month period ending February 2004 *alone*.

The COST study has the practical effect of understating the business tax burden in Alabama by intentionally not including the share of individual income taxes paid on the earnings of limited liability entities, or "LLEs," the number of which has grown exponentially since late 1993. The state-by-state data was not available to their researchers. But according to the Alabama Secretary of State's office, there were approximately 16,000 LLCs, LLPs and limited partnerships in Alabama at the end of 1993, while more than 68,000 existed as of February 2004. Nor does that include the approximately 42,000 S corporations doing business in Alabama. Even if one

disregards the economic downturn that hit Alabama in late 2000 or early 2001, no wonder the state's individual income tax revenues have increased dramatically over the past several years while corporate income tax revenues dropped, at least until recently: many existing corporations converted to the LLE form and there is strong evidence that a majority of new businesses, both large and small, are being formed as LLEs rather than "C" corporations. Of course, the owners, rather than the entity, are liable for the business' income tax.

The PARCA report, issued April 7, analyzes the COST study for Alabama and draws on the independent think tank's own data base as well. Over the years, PARCA has published a series of excellent reports on Alabama's tax structure. The full text of the new report can be found at:

<http://parca.samford.edu/ErnstYoung.pdf>.

It notes that Alabama's business tax structure differs in several respects from its regional neighbors, as the following table illustrates:

Type of Tax on Business	National Average	Average of 9 S.E. States	Alabama
Property taxes on business property	38.6%	36.3%	24.7%
General sales taxes on business inputs	24.8%	29.2%	26.3%
Excise and gross receipts taxes	11.0%	13.5%	22.9%*
License and other taxes	9.5%	9.0%	11.1%
Corporate income tax	8.6%	7.0%	8.8%*
Payroll taxes	7.5%	5.0%	6.2%
Total:	100%	100%	100%

While most states rely more heavily on business property taxes than Alabama, our state is "dramatically above the national average in its use of business excise and gross receipts taxes (22.9% vs. 11.0% of total business tax revenues)," according to PARCA. At the same time, the report suggests that the reason Alabama corporate income taxes are higher than almost all of its regional neighbors is the package of revenue raisers enacted in late 1999, and modified in 2001. Those bills increased both the corporate income tax and financial institution excise tax rate to 6.5%; imposed a business privilege tax on LLEs for the first time and up to a \$3 million alternative minimum tax on financial institution groups; required withholding of income taxes on LLEs with non-resident owners who refused to consent to tax jurisdiction or to file separate tax returns; and disallowed the deduction of certain royalties and interest payments to related companies unless one of several narrow exceptions is met.

The full impact of these changes is only now being witnessed. The latest ADOR Revenue Abstract seems to support that conclusion.

Our next newsletter will survey the various items of tax-related legislation enacted by the Alabama Legislature during its 2004 Regular Session, and some of the tax bills that didn't quite make it.

Notice required by federal law: This e-mail may constitute an advertisement or solicitation under U.S. law, if its primary purpose is to advertise or promote a commercial product or service. You may choose not to receive advertising and promotional messages from Bradley Arant Rose & White LLP at this e-mail address by forwarding this message to helpdesk@bradleyarant.com. If you do so, the sender of this message will be notified promptly. Our principal postal address is One Federal Place, 1819 Fifth Avenue North, Birmingham, AL 35203. Thank you. Bradley Arant Rose & White LLP.