The Reformation of Kentucky Tax Reform

A Presentation to the FTA Revenue Estimation Conference
Portland, Oregon

Greg Harkenrider
Chief State Forecaster
Office of State Budget Director
Commonwealth of Kentucky
July 27, 2006

Timeline

• Regular Session in 2004
  – Tax bill introduced, tied to budget, omnibus bill failed to pass both chambers
• Regular Session 2005
  – Tax Modernization bill passed, budget passed
  – License tax repealed, rates lowered, but ELT of PTE
• Regular Session 2006
  – Budget included modest AMC relief
  – Stand-Alone bill died
• Special Session 2006
  – Passage of HB1
  – Elimination of ELT of Income, Retain GR or GP tax
House Bill 272 - 2005 GA

One Tax: Liability is the Greater of 1, 2 or 3

1  Net income
   Net income x 6.00%
   = Net income tax

2  AMC
   Lesser of two alternative minimum calculations

3  $175 minimum
   (absolute minimum)

2a  Gross receipts
   Ky Gross receipts x 0.095%
   = Gross receipts AMC

Or

2b  Gross profits
   Ky Gross receipts - Ky Cost of goods sold
   Ky Gross profit x .75%
   = Gross profits AMC

Bursting the Balloon

- Euphoria lasted about 2 months
- CPA society started clamoring when preparing June 2005 declaration payments
- Receipts started pouring in
  - Great economy
  - Transfer from PIT to CIT
  - Loophole closings
The predicate for the “reformation” of tax reform

1. AMC is hurting small business
2. AMC and ELT injure start-ups and retard investment
3. ELT creates a taxpayer administrative burden
4. Opposition to retroactive effective dates in 2005 bill

The AMC as compared to a typical family

Family Profile
• Two income family, 1 child combined income of $80,000
• KY Income Tax: $4,039

Business Profile
• Income tax obligation under traditional calculation $3,000
• Gross Receipts: $4.0 Million @ $950 per $ mil
• AMC Liability: $3,800

A $4 million dollar company paying under the AMC pays less income tax than this family of 4
AMC payers are about 31% of business taxpayers

Profile of AMC taxpayers
(Based on Corporate Coded Estimates)

- 50% paid by less than 1% AMC payers (71 entities)
- 75% paid by less than 5% of AMC payers (419 entities)
- 90% paid by 17% of AMC payers (1,556 entities)
AMC increment hits large multi-state taxpayers

Reminder: “A” is for Alternative

<table>
<thead>
<tr>
<th>If your total tax was ...</th>
<th>Your net income could have been as much as ...</th>
<th>And your gross receipts could have been as much as ...</th>
<th>And your gross profits could have been as much as ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>$175</td>
<td>$4,375</td>
<td>$184,211</td>
<td>$23,333</td>
</tr>
<tr>
<td>$1,000</td>
<td>$25,000</td>
<td>$1,052,632</td>
<td>$133,333</td>
</tr>
<tr>
<td>$2,000</td>
<td>$50,000</td>
<td>$2,105,263</td>
<td>$266,667</td>
</tr>
</tbody>
</table>
AMC Relief in 2006 Budget

- Governor Fletcher’s Proposal
  - Complete AMC relief for corporations with Kentucky gross receipts less than 2 million
  - Proportional relief for all corporations with Kentucky gross receipts less than 10 million
  - Fair and fiscally responsible
  - Keeps the stability aspect of the AMC without being burdensome to small business

AMC Relief by the Numbers

- Estimates indicate the 60,000 corporations (mostly LLE’s) have gross receipts less than $2 million, with an additional 10,000 businesses with gross receipts between $2 million and $10 million
- Fiscal impact:
  - FY07: $3.2 million
  - FY08: $9.7 million
Options for additional AMC relief for small business

<table>
<thead>
<tr>
<th>Lower KY GR Threshold</th>
<th>Upper KY GR Threshold</th>
<th>Fiscal Impact ($Millions, FY08)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 million</td>
<td>$8 million</td>
<td>$5.8 million</td>
</tr>
<tr>
<td>$1 million</td>
<td>$10 million</td>
<td>$6.8 million</td>
</tr>
<tr>
<td>$1.5 million</td>
<td>$8 million</td>
<td>$7.5 million</td>
</tr>
<tr>
<td>$1.5 million</td>
<td>$10 million</td>
<td>$9.0 million</td>
</tr>
<tr>
<td>$2 million</td>
<td>$10 million</td>
<td>$11.0 million</td>
</tr>
<tr>
<td>$2 million</td>
<td>No Second Tier</td>
<td>$5.0 million</td>
</tr>
<tr>
<td>$25 million</td>
<td>No Second Tier</td>
<td>$47.8 million</td>
</tr>
</tbody>
</table>

Undressing the wolf ...

Moving from AMC relief to repealing ELT

1. Entity level taxation imposes a tax on profitable entities before the taxable income can be offset by losses at the individual level.
2. Owners of PTE cannot claim ELT as a deduction on home state individual income tax forms.
3. Loss companies really don’t like to pay taxes.
4. Significant issue was loophole closing.
House Bill 1: Structural Changes and Small Business Tax Relief

- Federal Conformity on taxation of income beginning in 2007 – returns pass-through entities to prior income tax filing status
- AMC Relief for 2006
- New Limited Liability Entity Tax for 2007
- Reduction of top corporate rate on income to 6% is preserved
- Clarification of Cost of Goods Sold

House Bill 1 – 2006 Special Session

Two Taxes: With off-setting credits

<table>
<thead>
<tr>
<th></th>
<th>Net income</th>
<th>and</th>
<th>Limited Liability Entity Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Net income</td>
<td></td>
<td>Lesser of two calculations</td>
</tr>
<tr>
<td></td>
<td>x 6.00%</td>
<td></td>
<td>with a minimum of $175</td>
</tr>
<tr>
<td></td>
<td>= Net income tax</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2a

<table>
<thead>
<tr>
<th>Gross receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ky Gross receipts</td>
</tr>
<tr>
<td>= Gross receipts LLET</td>
</tr>
</tbody>
</table>

2b

<table>
<thead>
<tr>
<th>Gross profits</th>
</tr>
</thead>
</table>
| Ky Gross receipts - Ky Cost of goods sold | x 0.75%
| = Gross profits LLET |
House Bill 1 – 2006 Special Session
Credit for LLET given on Income Tax

1. Limited Liability Entity Tax

   Lesser of two calculations with a minimum of $175

2. Net income

   \[\text{Net income} \times 0.06 = \text{Net income tax}\]

Less

LLET Tax Credit

Credit = LLET Tax less $175 minimum. Limited to use against tax on income from the entity that paid the tax. Non-refundable. Does not carry forward.

Exemptions from the Limited Liability Entity Tax

- Entities with Gross Receipts or Gross Profits at or below $3 million (still owe the minimum $175)
- Cooperatives, including homeowners’ associations and political organizations

<table>
<thead>
<tr>
<th>Financial institutions</th>
<th>Open-end registered investment companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings and loan associations</td>
<td>Fluidized bed energy production facilities</td>
</tr>
<tr>
<td>Banks for cooperatives</td>
<td>Alcohol production facilities</td>
</tr>
<tr>
<td>Production credit associations</td>
<td>Real estate investment trusts</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>Regulated investment companies</td>
</tr>
<tr>
<td>Exempt entities under Section 501 of the IRC</td>
<td>Real estate mortgage investment conduits</td>
</tr>
<tr>
<td>Public service corporations</td>
<td>Personal service corporations</td>
</tr>
<tr>
<td>Publicly traded partnerships</td>
<td>Religious, educational, and charitable corporations</td>
</tr>
</tbody>
</table>
Federal Conformity Aspect of HB1

Corporate Income Tax
• Federal definition of “corporation”

Limited Liability Entity Tax
• All corporations and entities with limited liability, except...
• Tax is withheld at entity level for non-resident owners

Individual Income Tax
• Individual owners of pass-through entities

House Bill 1: Structural Changes and Small Business Tax Relief

• Annual cost of approximately $41 million upon full implementation
• Over 70,000 businesses stand to benefit from reduced taxes
• Changes the answer to the questions:
  • Who pays the tax?
  • How much is owed?
How much is owed?

Corporate Income Tax
- Top rate of 6%*

Individual Income Tax
- Top rate of 6%

Limited Liability Entity Tax
- Lesser of: $950 per million on Ky gross receipts OR $7,500 per million of Ky gross profits.
- Less credit for firms between $3 and $6 million of gross receipts or gross profits.
- Minimum of $175

Examples of AMC Relief

- Company Profile:
  - $1,750,000 in gross receipts
  - $25,000 in taxable profits
- Entity Tax Liability under HB 272
  - $1,662.50 in AMC
  - $1,000 on income calculation
  - Pay $1,662.50

- Entity Tax Liability with AMC fix
  - $0 in AMC (since 0 rate on first $3.0 million of gross receipts)
  - $1,000 on income calculation
  - Pay $1,000
- Savings -- $662.50

*Note: Top rate is 7% for 2005 and 2006
Examples of AMC Relief

- **Company Profile:**
  - $1,750,000 in gross receipts
  - Loss Company
- **Entity Tax Liability under HB 272**
  - $1,662,50 in AMC
  - $0 on income calculation
  - Pay $1,662.50

- **Entity Tax Liability with AMC fix**
  - $0 in AMC (since 0 rate on first $3.0 million of gross receipts)
  - $0 on income calculation
  - Pay $175 minimum
- **Savings -- $1,487.50**

AMC relief is significant for small businesses

![Graph showing AMC and LLE GP Tax Calculation for firms with total Gross Profits at or below $3 million pay only $175]
AMC relief is significant for small businesses

Firms with total Gross Receipts at or below $3 million pay only $175

Lessons Learned

• Get your data read now
• Don’t underestimate loophole closings
  – Single factor apportionment for PTE
  – 50% loss limitation
  – Related-Party transactions
• Entity level taxation and its effect on tax base
Combining Losses and Profits

The Reformation of Kentucky Tax Reform

A Presentation to the FTA Revenue Estimation Conference
Portland, Oregon

Greg Harkenrider
Chief State Forecaster
Office of State Budget Director
Commonwealth of Kentucky
July 27, 2006