

# The Reformation of Kentucky Tax Reform

A Presentation to the FTA Revenue Estimation Conference  
Portland, Oregon

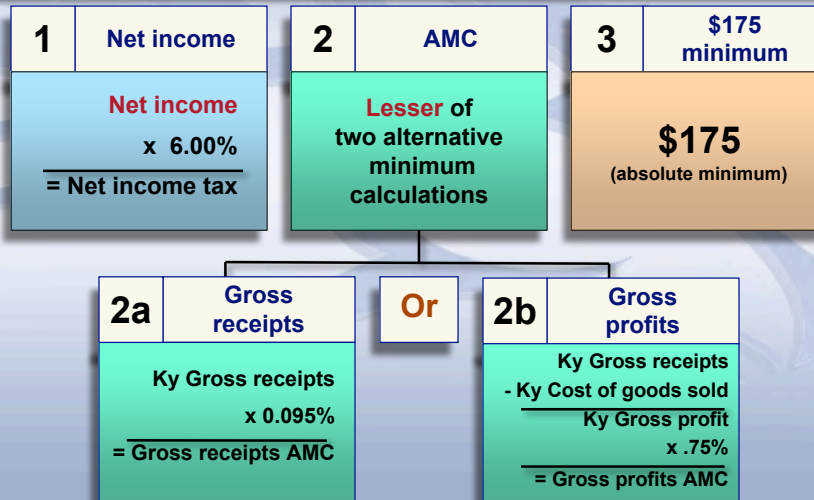
**Greg Harkenrider**  
**Chief State Forecaster**  
Office of State Budget Director  
Commonwealth of Kentucky  
July 27, 2006

## 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  - License tax repealed, rates lowered, but ELT of PTE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



## 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**

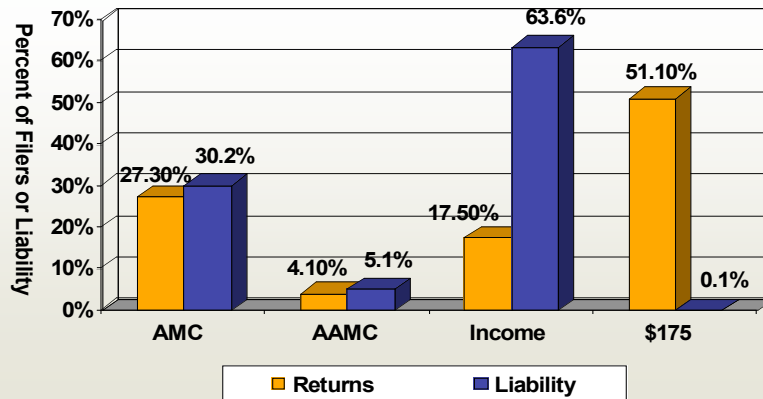


### Business Profile

- 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

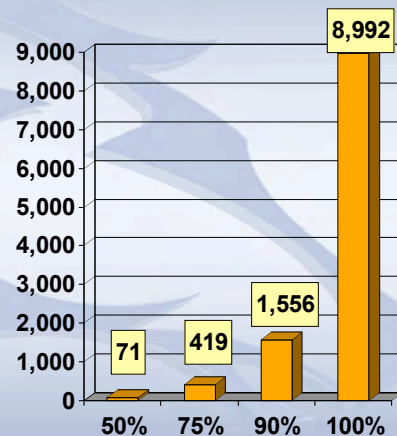
## AMC payers are about 31% of business taxpayers



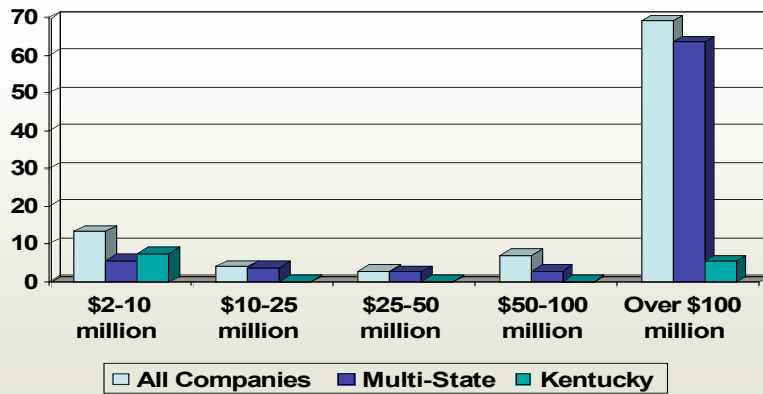
## Profile of AMC taxpayers

(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

If your total tax was ...	Your net income could have been as much as ...	And your gross receipts could have been as much as ...	And your gross profits could have been as much as ...
\$175	\$4,375	\$184,211	\$23,333
\$1,000	\$25,000	\$1,052,632	\$133,333
\$2,000	\$50,000	\$2,105,263	\$266,667

## 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

Lower KY GR Threshold	Upper KY GR Threshold	Fiscal Impact (\$Millions, FY08)
\$1 million	\$8 million	\$5.8 million
\$1 million	\$10 million	\$6.8 million
\$1.5 million	\$8 million	\$7.5 million
\$1.5 million	\$10 million	\$9.0 million
\$2 million	\$10 million	\$11.0 million
\$2 million	No Second Tier	\$5.0 million
\$25 million	No Second Tier	\$47.8 million

## Undressing the wolf ...

### Moving from AMC relief to repealing ELT

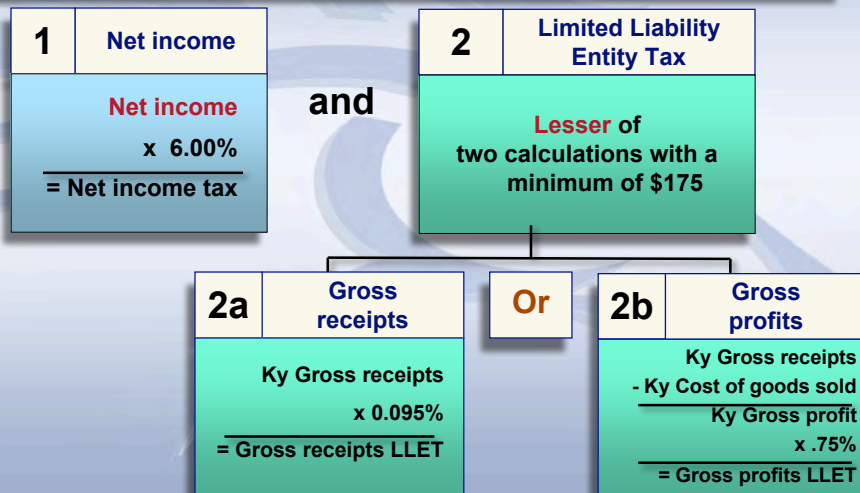
1. Entity level taxation imposes a tax on profitable entities before the taxable income can be offset by losses at the individual level.
2. Owners of PTE cannot claim ELT as a deduction on home state individual income tax forms
3. Loss companies really don't like to pay taxes
4. Significant issue was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



## House Bill 1: Structural Changes and Small Business Tax Relief

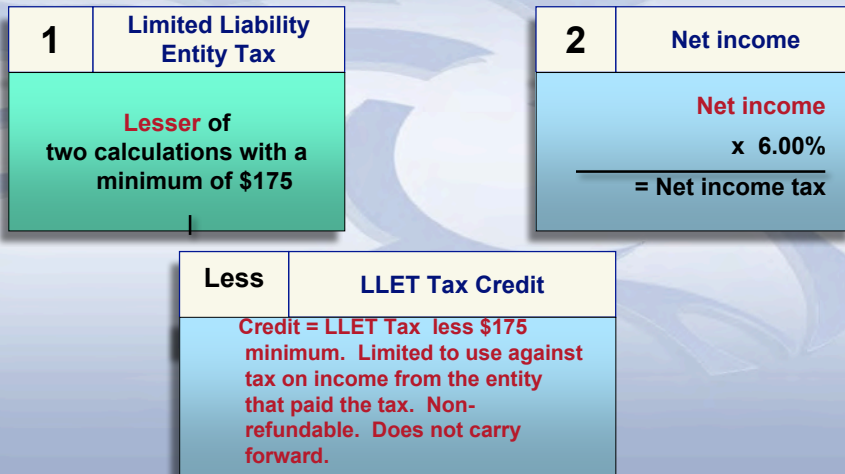
- Federal Conformity on taxation of income beginning in 2007 – returns pass-through entities to prior income tax filing status
- AMC Relief for 2006
- New Limited Liability Entity Tax for 2007
- Reduction of top corporate rate on income to 6% is preserved
- Clarification of Cost of Goods Sold

## House Bill 1 – 2006 Special Session Two Taxes : With off-setting credits





**House Bill 1 – 2006 Special Session**  
**Credit for LLET given on Income Tax**



**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**

Financial institutions	Open-end registered investment companies
Savings and loan associations	Fluidized bed energy production facilities
Banks for cooperatives	Alcohol production facilities
Production credit associations	Real estate investment trusts
Insurance companies	Regulated investment companies
Exempt entities under Section 501 of the IRC	Real estate mortgage investment conduits
Public service corporations	Personal service corporations
Publicly traded partnerships	Religious, educational, and charitable corporations

## **Federal Conformity Aspect of HB1**

### **Corporate Income Tax**

- Federal definition of “corporation”

### **Individual Income Tax**

- Individual owners of pass-through entities

### **Limited Liability Entity Tax**

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

## **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%

\*Note: Top rate is 7% for 2005 and 2006

### 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

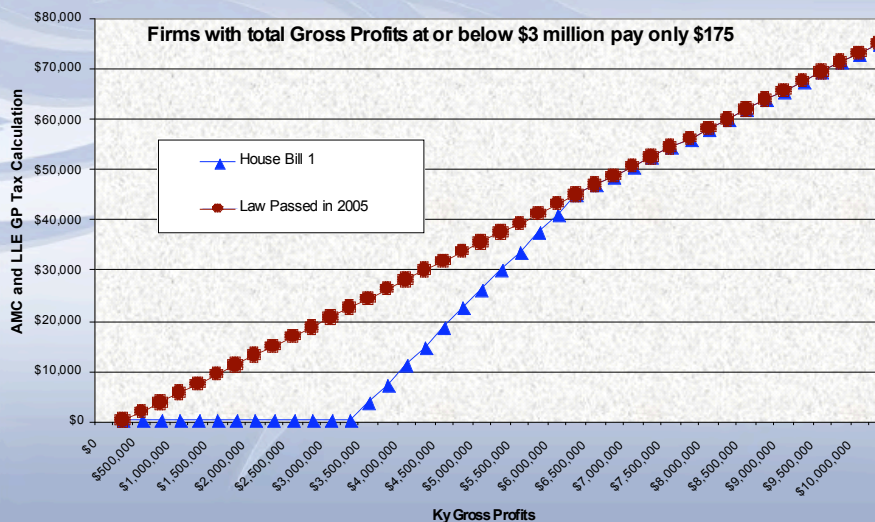
- Company Profile:
  - \$1,750,000 in gross receipts
  - \$25,000 in taxable profits
- Entity Tax Liability under HB 272
  - \$1,662,50 in AMC
  - \$1,000 on income calculation
  - Pay \$1,662.50

- 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

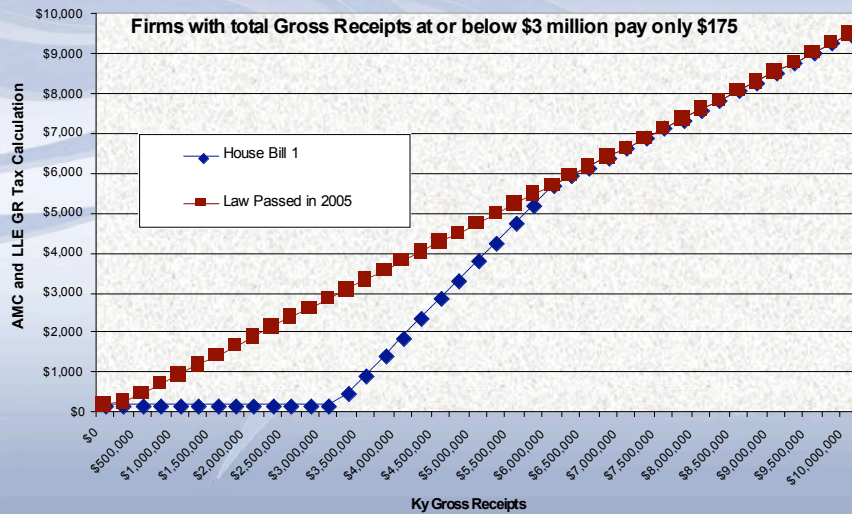
## Examples of AMC Relief

- **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



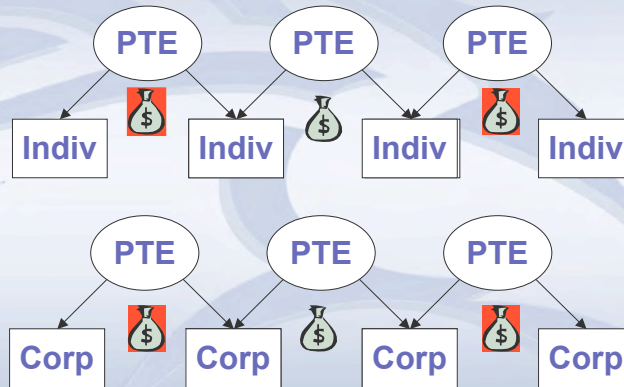
## AMC relief is significant for small businesses



## 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