

RILEY'S TAX REFORM PACKAGE MEETS THE LEGISLATURE: AN UPDATE

ON THE GOVERNOR'S \$1.3 BILLION EARTH SHAKING PROPOSAL.

The Bob Riley tax reform express pulled into the State House Station a couple of weeks ago, and the little engine that could met its first passengers on the track to referendum. Most would-be passengers seemed most interested in House Bill 3, relating to ad valorem tax, and House Bill 19, relating to corporate and individual income tax. To push this train analogy perhaps too far and get a little cheeky, House Bill 3 was forced to take on a few more riders that only had partial fare, while House Bill 19 almost suffered an Indian attack and a raid by the Hole in the Wall Gang led by Geoffrey the REIT.

As you know, the property tax and income tax proposals anchor the Governor's reform package, accounting for \$430 million and \$460 million, respectively. There were a number of suspenseful moments as this shiny new engine made its way through the House of Representatives, but these two foundation stones of the revenue package seemed to weather the ride through the wild country pretty well. Their eight sister tax bills negotiated their way through the House without any material change.

A. The Property Tax Bill Is Only Winged.

House Bill 3, relating to property tax, made it to the House floor after a full two weeks of haggling and after a few minor flesh wounds in the name of fairness to the family farmer.

The bill as amended will increase the tax owed on a 500 acre farm from \$176 to approximately \$900, still a five-fold increase. The following amendments cost the bill \$20 million, a small concession out of the total.

Current use will live to be debated another day, and I would urge anyone wishing to alter the valuation to include all interested parties in the discussion. There are now, and there will always be, misconceptions and room for argument relating to current use. While current use valuation does give an unfair advantage to larger landowners, it levels the playing field for the smaller farmers. Hopefully, a solution will be reached one day that will remove the perception that a significant portion of our landowners are getting away with something come property tax time.

One amendment exempted from the tax the first \$150,000 of farm improvements. This provides an incentive to agriculture similar to those we have seen for other businesses, and it will cost about \$3.5 million. Although this amendment may allow for some gaming by the less

scrupulous taxpayer, this exemption could be easily monitored, and may provide overall fairness in the property valuation process.

The 200 acre farmstead exemption written into the original bill also came under scrutiny because it did not allow owners of separated land parcels to claim their entire farmstead. This problem was corrected by allowing the cumulation of separated land in taking the exemption. This will cost \$9 million.

The next amendment could prove more costly. The new language reads:

"For the purposes of this subdivision, the term 'owner or owners' of farmstead property shall include individuals, trusts, estates, corporations, associations, partnerships, joint ventures, limited partnerships and limited liability companies."

This will be an easy provision for less scrupulous landholders to manipulate. Have we forgotten just how much land Bernie Ebbers bought in this state when Worldcom was going under? I'm not trying to sound like chicken little here, but we have seen the corporate income tax base vanish at the hands of deft accounting gamesmanship.

This amendment designed to benefit the Alabama farmer regardless of the manner in which he structures his business may unwittingly diminish our tax roles. Let's take, for example, a holding company seeking a safe investment of a few million dollars. It buys three thousand acres of timber land for approximately five million dollars. Then it splits the land up into fifteen to sixteen different parcels and forms the same number of trusts or limited liability companies to manage the land. Each sub-parcel now qualifies for the farmstead exemption. The result will be a loss of State ad valorem tax revenue until the land is sold. This would be completely unfair to the Alabama farmer we're trying to protect, and someone needs the authority to expose these types of operations.

B. Business Assault on the Income Tax Bill: The Empire Strikes Back.

The original income tax bill was designed to raise over \$400 million from individuals and about \$45 million from corporations. There are two points to make regarding the Administration's proposal. First, corporate income tax collected in Alabama has declined by \$200 million since 2000, and second, the original bill's touted purpose was to reform our tax structure to be fair and equitable.

However, the only tax increase on corporations will eliminate 75 % of their Federal income tax deduction compared to the entire deduction being taken from individuals.

Also, the Governor's vaunted comprehensive package that took six months to develop failed to improve statutory authority that would give the Department of Revenue needed powers to fight abusive tax shelters that so frequently rob our State's tax dollars. Worse, last week the tax practitioners came along and tried to decimate the few tax avoidance prevention powers the Commissioner does have.

The scope of the Revenue Commissioner's tax audit powers enjoyed a roller coaster ride as the income tax bill clickety-clacked through the House Committee. Early in the discussions, Chairman Knight discovered that a version of the bill prior to its introduction in the House would have closed the corporate tax loophole related to Real Estate Investment Trusts, or REITs. Under the REIT tax shelter device, financial institutions, insurance companies, and large retailers form REITs and transfer property they own into them. The trust charges the parent corporation rent and dividends the rent money back to the parent. The REIT deducts the payment and the parent deducts the receipt. Voila: The money is laundered from parent to REIT to parent, and no one pays Alabama income tax on it. By contrast, the Federal tax laws do not allow the parent to deduct the dividend received, and neither do many other states. But, of course, Alabama does.

So, when the Finance Department was questioned about the REIT reform language being removed it answered with, "This package is fair and corporations will be taxed at rates competitive with our neighbors". What the Finance Department didn't say is that the corporate tax base that we use to assess our 6.5% income tax rate has been significantly reduced by loopholes, and we will continue to collect less tax than our neighbors as a result. We have discussed this problem in previous articles, and the Committee seemed ready to clamp down on REITs until the big business interests slathered on the war paint and threatened certain death to the income tax bill if the Committee didn't move on.

Curiously, the Administration's rationale for not closing the REIT loophole was that the Revenue Commissioner was given so-called 482 powers under the 2001 tax reform legislation.

The Commissioner's 482 powers allow him to reallocate a taxpayer's income, deductions and other tax attributes to correctly reflect a taxpayer's income generated in Alabama. This authority could theoretically be used to collect tax lost to the REIT loophole, but a statute barring the deduction of REIT dividends altogether would kill the loophole and save the Department's resources.

To date, the Commissioner has never used his 482 powers, and there will be legal battles when he

does. Under the Administration's REIT reform via 482 powers proposal, we can expect our much needed tax dollars around 2010.

Don't hold your breath for more good News. The very day after the REIT debate, the Administration slid in an unannounced amendment to eviscerate the Commissioner's 482 powers. One day the Administration wants to use 482 powers to fight loopholes, and the next day it wants to strip them away. The amendment would have barred uniform combined reporting, which allows the Commissioner to flex his 482 muscle by ignoring business tax shell games and to reallocate its tax payers' income, deductions and other tax attributes accordingly.

For the Administration to pull a bait and switch on the use of 482 powers within 24 hours has led us to investigate further.

Come to find out the plot gets a little more interesting. While the 482 gutting amendment was circulating, a well-known tax lawyer for the Business Council of Alabama was directing traffic. It appears that the Administration's own Finance Department, together with the supposed independent counsel for the Committee and the Legislative Fiscal Office, and counsel for the Business Council of Alabama cooked up the amendment to strip the Commissioner's 482 powers.

Representatives from AEA, the Department of Revenue, and the Citizens' Commitment vehemently opposed the amendment, and the Committee then decided to take a short recess.

The Commissioner of Revenue, Dwight Carlisle, then appeared on the scene with a few choice words for BCA's tax counsel, and put an end to the amendment by explaining to the Committee its dire effects on his audit powers. Once back in session, the Committee then killed the business friendly amendment immediately. This turn of events raises independence and ethical questions that should be directed to the Committee's counsel and to the Administration. Are they providing the Legislature with neutral information and advice, or are they protecting private business interests? You decide.

We have written about the many problems Commissioner Carlisle has inherited in running the Department of Revenue, and we have received some positive feedback related to the efforts he has taken to improve the Department. Although this is not a one man fight, it was cathartic to see the Commissioner stand up for the Department of Revenue. Despite the tough job he faces, we can be assured that Commissioner Carlisle has no problem getting his knuckles bloodied while standing up against big business lobbyists.

Other than the ethical dilemma of legal independence the Committee faced, the income tax bill experienced little change from Governor Riley's original proposal before making its way to the House floor for approval.

C. Conclusion

The two wheel horses of the Riley reform package, income and property tax, appear to be on their way to the Senate relatively intact. Although the Riley proposal does not crack down on business tax loopholes, Revenue Commissioner Carlisle has shown his willingness to come out swinging, making use of his 482 powers to crack down on large tax cheats and their counsel.