

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. Frenz
(205) 521-8216
sfrenz@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.

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Riley Administration Passes Massive Tax Reform and Accountability Package

On Wednesday, June 11, Governor Bob Riley signed into law a package of 19 bills that had been passed by the Alabama Legislature during the previous week and over the weekend as a part of the special session called by the Governor on May 19. In addition, the Governor signed into law a bill championed by the Alabama Education Association (AEA) that will obligate the State and local school boards to rehire approximately 2,300 teachers and support workers who were given "pink slips" several weeks ago, even if the Governor's tax reform/accountability package is defeated in the polls. Other than the mandatory teacher rehire bill, the package of bills is contingent on voter approval of the related constitutional amendment in a statewide referendum scheduled for Tuesday, September 9. Only one major component of the package fell away—HB 22, a controversial one mill ad valorem tax on certain intangibles such as stocks, bonds and mutual fund investments. After having been pruned at every step of the legislative process, the bill quietly died in the Senate.

Although feelings around the state regarding the mood of the voters are mixed, Governor Riley was characteristically upbeat at the signing ceremony. "By signing these bills today, we give the people of our State a choice of two paths to follow. One path leads to progress, opportunity and accountability for all Alabamians [while] the other path leaves us mired with the same inefficient, wasteful and dysfunctional models that have left us at the bottom of so many lists for far too long." Mobile Senator Bradley Byrne added, "If anybody can sell this package, Governor Riley can." The package ultimately received the endorsement of the influential Business Council of Alabama and several other major trade associations such as Manufacture Alabama, as well as the AEA and several religious groups, while drawing opposition from the Alabama Forestry Association and the National Federation of Independent Business. The special session required to finalize the budgets for the fiscal year beginning October 1 is expected to begin only a few days after the September 9 referendum. Obviously, the tenor of that session will depend largely on that Tuesday's vote. If the voters reject the package, legislators must scramble to find a "Plan B," one that would not require another constitutional referendum.

The bills are projected to raise approximately \$1.2 billion when fully phased-in, which includes an estimated \$675 million to cover the deficit inherited by Riley from prior administrations and caused by the sour economy, for the fiscal year beginning October 1.

This SALT Bulletin will provide an overview of the major revenue bills in the Governor's package along with a brief summary of the accountability portion of the package. Special thanks to the Alabama Legislative Fiscal Office (LFO) for their excellent summary of these bills, upon which portions of this Bulletin are based.

1. HBs 1 and 3 (Acts 2003-78 and -119) – Constitutional Amendments and Related Matters. HB1 embodies the provisions that would effect certain changes to the income tax and ad valorem tax provisions contained in the Alabama Constitution of 1901, contingent on a favorable vote on September 9. The state ad valorem tax rate would be reduced from 6.5 to 3.5 mills, while state ad valorem assessment ratios will be increased to 100% for all classes of property except utility property (which remains unchanged – see below), effective October 1, 2003, subject to provisions in the enabling legislation intended to phase-in the increase over a four-year period. The local assessment ratio for Class II commercial and business real and tangible personal property would increase from 20% to 22% of fair market value immediately, with no phase-in. For local ad valorem tax purposes,

regulated utilities would transition over several years from an assessment ratio of 30% down to 22%, based on comparing the assessed value of their properties as of October 1, 2001 with the values derived from the new assessment. The effect is to immediately roll back property taxes on all public utilities to their 2001 level, for both state and local purposes, until such time as the frozen level of property taxes would, in the aggregate for all public utilities in the state, equal those taxes public utilities would pay at the lower 22% assessment rate, but in no event later than 2011.

Low-income housing property subject to government regulation would continue to be taxed by the State at the same rate in effect on October 1, 2002 (6.5 mills on a 20% rather than 100% assessment ratio), while vehicles owned by regulated utilities were moved from Class I to Class II, which covers motor vehicles used primarily for business purposes rather than by consumers. Another shift is "single family owner-occupied property" that is still under construction -- the uncompleted house and the lot, as well as empty lots in subdivisions that have previously been platted and developed but have not yet been sold. Those properties are moved from Class II to Class III, which is the general category for agricultural, forest and single-family owner-occupied residential property, and historic buildings and sites, reducing their local property tax burden by half, effective immediately.

Perhaps the most controversial change in the ad valorem tax area was the limitation placed on the amount of land subject to current use valuation. The 2,000 acre cap was inserted in the package in the Senate with the blessing of the Riley Administration and, to the surprise of many, was approved by the Legislature over the protests of large landowners. The 2,000 acre limitation, however, does not fully phase in until the fiscal year beginning October 1, 2006. Assessment ratios for current use property also increase to 100% of fair market value for state ad valorem tax purposes, beginning October 1, 2003, and subject to the enabling act phase-in provisions.

HB 1 also creates the Alabama Excellence Initiative Fund (AEIF), to be the recipient of much of the revenue generated by the tax package, rather than the existing Education Trust Fund or the General Fund. In the case of property taxes, 6.33% of the new revenue goes to the AEIF in 2004, eventually topping out in 2008 at 68.25%, with the balance each year going to the Education Trust Fund, the General Fund, and the pension fund. It was critical to the Governor that monies deposited in the new AEIF be unearmarked, despite initial resistance from AEA.

Effective for the first tax year beginning on or after January 1, 2003, the federal income tax deduction for individuals and corporations is reduced to 75%, and for years thereafter is repealed. Conversely, the corporate income tax rate and the financial institution excise tax (FIET) rate are reduced to 6%. The individual income tax maximum rate is increased from 5% to 6%, also effective January 1, 2004 (see HB 19 discussion below).

A little-publicized provision of the act amends the Education Trust Fund Rainy Day Account to require

replenishment of amounts withdrawn from the fund over a 5-year period beginning in the year following the year of withdrawal. Additionally, a new General Fund Rainy Day Account is proposed to be created within the Alabama Trust Fund which is, in many respects, identical to the Education Trust Fund Rainy Day Account. Assuming the September 9 vote is favorable, the account would be funded during the fiscal year beginning October 1, 2003 with approximately \$73 million from the Alabama Trust Fund. Readers may recall that the voters rejected the idea of a General Fund Rainy Day Account last year.

2. HB 3 (Act 2003-119), Ad Valorem Property Tax. HB 3 is tied to the constitutional amendment proposed by HB 1 and contains more detail regarding the Governor's property tax reform proposals. It would generate, when fully phased-in during fiscal year 2008, almost \$404 million in new state revenues. In addition to tracking HB 1 generally, a new "farmstead exemption" is created for state ad valorem tax purposes only. The exemption applies to the value of 200 acres of qualifying agricultural or forest property, or \$150,000 in assessed value of buildings or structures used in either of those activities, other than residences. However, the farmstead is only an alternative to the homestead exemption and no individual or individual and his/her spouse will be entitled to claim both. Many interpret this new exemption to require the individual to actually live on the property as well. Additionally, the state homestead exemption is increased from 160 acres to 200 acres maximum, limited by a \$50,000 maximum, to which level the homestead exemption is increased over a four-year period. This would amount to an increase from the present \$4,000 exemption, which equates to a \$40,000 exemption under the 100% assessment ratio regime. No change is made to the local homestead exemption, however (which is generally \$2,000 against county non-educational taxes only).

3. HB 11 (Act 2003-118), Sales, Use, and Rental Taxes. The major feature of this act levies a new 4% sales and use tax on charges for the installation, repair or fabrication of tangible personal property and on the sales price of warranty or service contracts for the repair of tangible personal property, excluding, however, repairs to/installation of items taxed at the so-called machine rate or those excluded or exempted from taxation (such as pollution control equipment or parts and supplies used in repairing large ships).

The bill would also increase the rental tax on automotive vehicles from 1.5% to 3% of rental charges, while increasing the sales and use tax on the sale of automotive vehicles from 2% to 2.5%, including so-called "casual sales" by individuals. The current excise tax levied on lubricating oil (which includes motor oil) would be repealed, making the product subject to the higher 4% sales and use tax rate instead. When fully implemented, this bill is projected by LFO to increase revenue by \$139 million dollars per year and is effective for tax years beginning after September 30, 2003, assuming the September 9 referendum is successful.

4. HB 14 (Act 2003-102), Business Privilege Tax. While levying a business privilege tax for the first time on statutory

business trusts doing business in Alabama, HB 14 also repeals the ambiguous financial institution group or "FIG" tax of up to \$3 million annually, causing financial institutions' taxes to fall from \$3 million to the normal privilege cap of \$15,000 per year. The bill also achieves the laudable goal of allowing the Alabama Department of Revenue (ADOR) to combine the corporate income tax and business privilege tax returns so as to make them due at the same time each year, and also clarifies when the initial BPT return is due. The higher \$3,000,000 and \$500,000 caps for insurance companies and REITs, respectively, were retained. LFO projects this bill to reduce revenue by \$8.4 million annually beginning in fiscal year 2004.

5. HB 19 (Act 2003-116), Individual and Corporate Income Tax. The other major component of Governor Riley's tax reform package is the income tax bill, which LFO projects will raise, when fully phased-in, approximately \$421 million annually. Under the bill as passed, however, the phase-in isn't complete until fiscal year 2009.

Linking with HB 1, HB 19 would substantially alter the income taxation of lower-income and middle class taxpayers by substantially increasing the Alabama standard deduction, eventually equaling the amount allowed by federal law, and allowing adjustments thereafter for inflation as well. Personal exemptions and dependent exemptions will also be increased next year, to an amount equal to 70% of those allowed under federal law, which are also adjusted annually for inflation.

On the other hand, the bill repeals a number of current individual income tax deductions, and in the future only four will be allowable: (a) qualified residence interest (mortgage interest); (b) charitable contributions to the extent allowed for federal income tax purposes; (c) expenses paid for medical care in excess of 7.5% of adjusted gross income (in conformity with federal rules); and (d) qualifying adoption expenses. The largest hits to upper-income taxpayers would therefore include the loss of the federal income tax deduction as well as the deduction for FICA/SECA, occupational license taxes, ad valorem taxes, investment interest, casualty losses, and several other miscellaneous, specialized deductions, such as home office deductions, unreimbursed employee business expenses, tax preparation and investment adviser fees, etc.

The beginning point on the Alabama income tax return would become federal adjusted gross income, and unlike earlier versions of the bill, would allow subsequent changes to the Internal Revenue Code to be automatically incorporated into Alabama law. There was much discussion about "freezing" the reference to the Internal Revenue Code so that Congressional changes after December 31, 2002 would have to be affirmatively voted on, item-by-item, annually by the Alabama Legislature and approved by the Governor. The business community and many tax practitioners argued strongly against that change and, as a result, it was dropped during deliberations by the House GF&A Committee.

The bill also incorporates substantial portions of the pending "Subchapter J and Business Trust Conformity Act of 2003," thus adopting the federal income tax rules for trusts and

estates as well as for statutory business trusts, all effective January 1, 2004, again provided the September 9 referendum is favorable. Readers who wish to review a detailed summary of the business and grantor trust changes should contact either Chris Grissom or Bruce Ely for a copy.

With respect to tax rates, individuals will now be taxed at either 5% of net income or 6% of net income, with a \$75,000 breakpoint for singles or married individuals filing separately, and a \$150,000 breakpoint for married individuals filing jointly or surviving spouses. Trusts and estates would not be granted a standard deduction or personal exemption but would pay income tax at the rate of 5% of net income not in excess of \$9,500 and 6% of net income in excess of that figure. As indicated above, the corporate income tax rate was dropped from 6.5% to 6% to reflect the repeal of the federal income tax deduction and in order to keep Alabama within the midpoint range of other southeastern states' corporate tax rates.

At the last minute, several groups were successful in amending the bill to exempt distributions from profit-sharing and 401(k) (defined contribution) retirement plans, beginning in 2006 at \$7,000 per year, and up to \$40,000 per year in 2011. Under current law, distributions from defined benefit (pension) plans are totally exempt, while distributions from profit-sharing plans are totally taxable.

Items that were either stripped from the bill, or amendments that were rejected, included proposals to: (a) force multistate companies to file unitary combined returns, rather than separate income tax returns; (b) tax resident shareholders or members of multistate pass-through entities on their pro rata or distributive share of the entities' entire multistate income, rather than allowing the entity to allocate and apportion its income among all the states in which it does business, including those states that do not levy a net income tax; (c) expand the nonresident partner withholding and contingent liability rules now applicable only to Subchapter K entities (partnerships and LLCs) to include S corporations, trusts, and estates; and (d) limit the use of existing net operating loss (NOL) carryovers, including NOLs acquired in certain tax-free reorganizations. However, the 2 year NOL carryback for individuals will be phased out over the next 2 years, in conformity with the corporate rules.

6. HB 25 (Act 2003-115), Financial Institution Excise Tax. Consistent with the corporate income tax changes, this act would simultaneously reduce the FIET rate from 6.5% to 6% and repeal the deduction for federal income taxes paid by those institutions. Additionally, the special credits that financial institutions are entitled to claim for local sales, use and rental taxes would be phased-out over a 4-year period, while credit unions will continue to receive the full amount of their credits.

Initially, the idea was to repeal the FIET and instead subject financial institutions to the corporate income tax, parallel with federal income tax law. However, LFO projected there would be a substantial revenue loss by doing so, which suspended further consideration of the proposal.

7. HB 2 (Act 2003-109), Tobacco Taxes. This legislation would increase cigarette taxes by 14.5¢ per pack and provide a 100% increase in the tax for all other tobacco products. In return, however, the legislation prohibits local governments from increasing cigarette taxes after the effective date of the act. LFO predicts the bill eventually will raise approximately \$52.4 million in FY 2005 and thereafter.

8. HB 4 (Act 2003-108), Utility Gross Receipts Taxes. Although this bill is projected to be revenue neutral, it does so by a mixture of rate changes. First, the rate of the utility gross receipts tax and utilities service tax increases from 4% to 5.5%, while the 2.2% utility license tax is repealed. The utility tax increase is also extended to municipal and other publicly-owned electric cooperatives and their customers, while counties continue to be barred from levying their own privilege or license tax on certain utilities.

9. HB 7 (Act 2003-107), Deed and Mortgage Recording Taxes. If the September 9 referendum is approved, this bill is projected to raise approximately \$44.8 million each year by doubling the deed recording tax and mortgage recording tax for mortgages and deeds filed after October 1, 2003.

10. HB 13 (Act 2003-101), Insurance Premium Taxes. Upon full implementation, this bill is projected to raise approximately \$5.2 million, by limiting the existing premium credit for in-state companies with heavy real estate investments and a large number of employees and by reducing the credit against the business privilege tax from 60% of the tax to 30%.

Summary of Accountability Measures

A fundamental precept of the Governor's tax reform package was the simultaneous passage of his education and government accountability bills. Following is a summary of each.

1. SB 1 (Act 2003-104), Fiscal Year 2004 Education Budget Revisions. As mentioned above, this bill was crucial to AEA's support of the Riley package and requires that the fiscal year 2004 education budget provide funding to pay salaries and fringe benefits of teachers, instructional support, and classified personnel for local boards of education, the Department of Youth Services, and the Alabama Institute for the Deaf and Blind, and requires each board and agency to employ the same number of instructional support and classified staff in fiscal year 2004 as were employed in fiscal year 2003, unless there is a decline in average daily class attendance. This bill is not linked to the ratification of the proposed constitutional amendment.

2. Senate Bills 2, 3, 4, 7, 10, 24 and 40. These bills are voluminous and are summarized in excellent detail on the LFO website:

www.lfo.state.al.us/2003_first_special_session legis LONG.htm.

These bills include provisions for: streamlining the teacher and other education employee suspension and termination processes; increasing the number of school days from 175 days to 180 days, over a 5 year phase-in period; awarding scholarships for teachers who agree to teach in subject matter areas suffering from teacher shortages and those who agree to teach in underserved geographic areas; repealing tenure protection for new assistant principals, financial officers, and instructional supervisors; imposing penalties for withholding or knowingly or carelessly providing inaccurate financial information to school boards or to the State Board of Education and imposing liability on school board members for misappropriation of funds; and creating a Georgia-like student scholarship program for qualifying Alabama residents who attend in-state colleges, universities or 2-year colleges and who have a minimum GPA of 3.0 and a composite test score of at least 20 on the ACT or the equivalent score on the SAT (except for attendance at 2 year colleges). The latter program only applies to undergraduate studies and has a limited amount of funding for the first year of implementation -- fiscal year 2005.

The accountability package also contains changes to the state employees and teachers health insurance program and to address the so-called "pass-through pork" issue. HB 9 (Act 2003-117) substantially increases the share of health insurance premiums that must be paid by both state employees and teachers but delays implementation of those increases until fiscal year 2005 and, even then, is only effective in years in which a salary increase is granted. Similarly, retiree contribution amounts will increase as retiree benefit increases are granted. Finally, SB 16 (Act 2003-113) defines and prohibits "pass-through appropriations" and imposes criminal penalties on agency directors who violate the provisions of the act, while also subjecting them to termination. Agency directors will be obligated to report to the Governor any directives they receive from legislators or others regarding pass-through appropriations and must also notify the legislator(s) in question. As with the other accountability measures, this act will not become effective unless the voters approve the related constitutional amendments on September 9.

The Legislature will meet for its final day of the 2003 regular session on Monday, June 16. The regular session will end without the Legislature having passed either the general fund or education trust fund budgets. According to George Harris, Chairman of our State Governmental Affairs and Economic Development Practice Group, the Riley Administration will likely consider calling at least one other special session, in advance of the September budget session, to address some economic development issues and perhaps legislation to assist existing industries in Alabama.

Please contact us if we can assist you or your clients in reviewing and analyzing the potential impact of these acts on your or their businesses. Members of our firm were involved in negotiations over several of these proposals.