KANSAS ASSOCIATION OF REALTORS®

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To: House Taxation Committee

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Subject: **HB 2430** – Opposing Changes to the Pass-Through Exemption that Increase the Income Tax Burden on Kansas Small Business Owners and Property Owners

Chairman Kleeb and members of the House Taxation Committee, thank you for the opportunity to provide testimony today on behalf of the Kansas Association of REALTORS® in opposition to **HB 2430**, which would increase the income tax burden on Kansas small business owners and property owners by excluding rent, royalty and other "passive" types of income from the pass-through exemption.

In addition, **HB 2430** would increase the income tax burden on Kansas small business owners that currently claim the pass-through exemption and do not pay payroll taxes for at least one full-time employee. Through our comments, we hope to provide some additional context to the discussion on this very important issue.

KAR is the state's largest professional trade association, representing nearly 8,000 members involved in both residential and commercial real estate and advocating on behalf of the state's 700,000 property owners for over 90 years. REALTORS® serve an important role in the state's economy and are dedicated to working with our elected officials to create better communities by supporting economic development, a high quality of life and providing affordable housing opportunities while protecting the rights of private property owners.

<u>Kansas REALTORS® Oppose the Proposal to Increase the Income Tax Burden on Property Owners by Differentiating "Active" and "Passive" Income for the Purposes of the Pass-Through Exemption</u>

During the 2012 Legislative Session, the Legislature passed **2012 HB 2117**, which was the Governor's original income tax reform proposal. As part of this legislation, the Legislature generally exempted all income from state income taxes that was received by a sole proprietor, partnership, sub-chapter S corporation, limited liability company or other similar business entities under schedules C, E and F on their federal income tax returns. This provision has become to be known as the "pass-through exemption" under Kansas state law.

Under current law, there is absolutely no distinction between "active" and "passive" income for the purposes of determining when income will be exempt under the pass-through exemption. As long as the income is received under schedule C, E or F on the individual's federal income tax return and he or she has a qualifying business entity, the income will generally be exempt from state income taxes.

Having said that, the new language found in Section 1(a)(3)(B) of **HB 2430** would differentiate between "active" and "passive" income and would subject all passive income received by a qualifying business entity on schedule C, E or F to state income taxes. Under this provision, active income would continue to be exempt from state income taxes under the pass-through exemption as long as several other specified tests were met.

If adopted by the Legislature, this provision of **HB 2430** would generate an additional $65 million in income tax revenue for the state general fund in FY 2016 and an additional $50 million in FY 2017. Effectively, the passage of this proposal would increase the income tax burden on Kansas taxpayers with passive income by $65 million in FY 2016.

Under federal tax statutes, which have been adopted by reference in Kansas state statutes, "passive" income is defined as "any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate." Generally, "active" income is income earned from wages, tips, salaries, commissions and income from "material participation" in a business owned in whole or in part by the taxpayer.

For the most part, any income derived from rent is generally considered to be passive income. Under Section 469 of the Internal Revenue Code, all rental activities are treated as passive income, regardless of the property owner's extent of participation in managing the property. As a result, if the Legislature were to pass this proposal, all rental income would no longer be exempt from state income taxes under the pass-through exemption.

Unfortunately, the federal regulations on this subject span over 69 pages of legalese and technical language and are extremely complex and cumbersome for the average taxpayer to comprehend and follow. While the passive activity provisions of the Internal Revenue Code became law nearly 30 years ago, they are still one of the most misunderstood and misapplied provisions of the federal tax statutes.

According to testimony provided by Gary Allerheilegen for the Kansas Society of Certified Public Accountants (Kansas CPAs) on **HB 2392**, the issue of whether to differentiate between the treatment of "active" and "passive" income was explicitly discussed and rejected by the Kansas Legislature during the 2012 Legislative Session due to the additional complexities imposed by this disparate treatment. According to Mr. Allerheilegen, applying different rules of income tax treatment to these two types of income will place an undue burden on the average Kansas taxpayer.

Obviously, Kansas REALTORS® strongly believe that property ownership is a strong force in creating economic growth and prosperity for the citizens of Kansas and income, property and sales tax revenue for state and local governments. In fact, the construction and real estate industries generate $19.4 billion in economic growth for Kansas each year, which is nearly 14% of the state's total gross domestic product (GDP) and the third-largest sector contribution to the state's overall economy.

Property ownership is hardly a "passive" investment in the Kansas economy. Even property owners who do not have an active role in managing their real estate investments contribute a large amount of resources to the Kansas economy and tax revenue to state and local governments. Not only do property owners pay property taxes to state and local governments, but property owners also spend large amounts of money each year with building trade providers (such as electricians, plumbers and roofers), construction companies, landscaping service providers, property management firms and various retail outlets (such as building supply and home improvement retailers).

In our opinion, there is no substantive difference between income earned by a property owner through real estate investments and other types of income earned by a business owner in a small business such as a service provider or retail outlet. Both types of income are used to stimulate the Kansas economy through the purchases of goods and services from other Kansas businesses and individuals.

Since this proposal would increase the income tax burden on Kansas state income taxpayers that own real property, might serve as a disincentive for investors to purchase additional property in the state and will make it difficult for average Kansas taxpayers to determine their state income tax burden, Kansas REALTORS® oppose the proposal to differentiate "active" and "passive" income for the purposes of the pass-through exemption.

<u>Kansas REALTORS® Oppose the Proposal to Increase the Income Tax Burden on Kansas Small Business Owners by Disallowing Business Entities with No Full-Time Employees from Utilizing the Pass-Through Exemption</u>

Under Section 1(b)(1) and (2) of **HB 2430**, a business entity that does not have at least one full-time employee that is compensated for at least 2,080 hours of work in a given tax year shall not be eligible to utilize the pass-through exemption for any income received by the business entity. Basically, independent small business owners with no full-time employees will now be subject to higher state income taxes than other small business owners.

Under this provision, any income received by an otherwise qualified business entity that has no full-time employees would be taxed at the appropriate marginal state income tax rate found in other sections of Kansas statutes (currently 4.6% for most taxpayers). In contrast, any income received by a qualified business entity that has at least one full-time employee would be taxed at a considerably lower marginal income tax rate (currently 2.7%).

Fundamentally, Kansas REALTORS® would respectfully disagree that a qualified business entity with one full-time employee and a similar otherwise qualified business entity with no employees generate a significantly different amount of economic growth for the Kansas economy.

In our opinion, the intent of the pass-through exemption created by **2012 HB 2117** was to provide Kansas small business owners with state income tax savings that would be used to EITHER hire more employees or make significant capital investments back into their small businesses. Just because a small business owner does not have any full-time employees, does not mean that they are not making significant capital investments and expanding their business using the income tax savings provided through the pass-through exemption.

Although the hiring of additional employees is one way to expand economic growth and increase tax revenues for state and local governments, it is not the only way to accomplish these objectives. When a small business owner with no full-time employees choose to expand his or her business through capital investments, this has a similar positive impact on the Kansas economy and state and local government tax revenues.

Unfortunately, income tax reductions do not immediately result in increased economic growth. It takes time for small business owners to respond to the stimulus created by the income tax reductions and to make the complicated decision to make corresponding capital investments in their respective small businesses.

In addition, small business owners are generally hesitant to make substantial capital investments in their respective small businesses unless they have certainty and consistency in the continuation of the income tax reductions. Every year since the enactment of the pass-through exemption, there has been considerable discussion in the news media and the community surrounding the potential for the Kansas Legislature to significantly modify or repeal the pass-through exemption.

In this challenging fiscal environment, relatively few rational business owners would embark on a multi-year capital investment plan relying on future cash flows from income tax reductions when they have absolutely no certainty and consistency in the continuation of those income tax reductions. In our opinion, many small business owners are currently sitting on the sidelines and waiting to determine if the Kansas Legislature will make major changes to or repeal the pass-through exemption.

Having said that, Kansas REALTORS® do not support any proposals that would discriminate against small business owners that do not have at least one full-time employee and subject them to a higher state income tax rate than other similar small businesses that happen to have full-time employees. As stated previously in this testimony, just because a small business does not have full-time employees does not mean that they are not making substantial contributions to the overall Kansas economy and state and local tax revenues.

Conclusion

In closing, we would respectfully request that the members of the House Taxation Committee oppose the provisions of **HB 2430**, which would increase the income tax burden on Kansas small business owners and property owners by excluding rent, royalty and other "passive" types of income from the pass-through exemption and disallowing small businesses with no full-time employees from utilizing the pass-through exemption.

Obviously, Kansas REALTORS® agree and understand that the Kansas Legislature will need to find additional sources of state tax revenue to close the projected budget deficit in FY 2016 and future fiscal years. However, we believe that if the Kansas Legislature is going to make major changes to the pass-through exemption, the changes should affect all types of small businesses equally and should not pick "winners and losers" based on the number of individuals employed or the type of income ("active" versus "passive") received by the business entity.

Over the last few weeks, we have discussed several proposals with members of this committee that would generate over $100 million in additional state income tax revenues without significantly and disproportionately increasing the income tax burden on any particular, singled-out group of Kansas taxpayers. In our opinion, there are many other proposals currently being discussed that would have a less burdensome impact on Kansas taxpayers than those proposals contained in **HB 2430**.

Again, thank you for the opportunity to provide comments to the committee on the proposals contained in **HB 2430**. At the appropriate time, we would welcome the opportunity to stand for questions and provide further comments on these very important issues.