State of Kansas
Senate Chamber

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Jim Denning
State Senator, 8th District

March 15, 2016

Representative Marvin Kleeb, Chairman
House Taxation Committee
300 SW 10th Avenue, 185-N
Topeka, KS 66612

RE: In support of HB 2444

Dear Mr. Chairman and Members of the Committee:

I'm appearing before the Committee today in support of modifying the tax exemption on pass through income provision from the 2012 tax policy. This would specifically modify the tax exemption on business income as reported by LLC's, S-Corps, Sole Proprietorships, and Farms on lines 12, 17, and 18 of the federal form 1040 individual income tax return.

You will hear later from businesses in industries all across Kansas supporting either repealing or modifying the pass through income tax exemption.

I served on the House Tax Committee in 2011 and 2012 under Vice Chairman, now Chairman Kleeb. From testimony presented this is how I understood the pass through exemption to work. In my mind the legislative intent and the testimony presented to me was to tax owner's salaries at the same proposed low rates as W-2 type employees would be. Then allow the **NON-WAGE** income or working capital to pass through tax free. Pass through entities can be; Sole Proprietorships, LLC's, Sub-S, Farms, and Operating Partnerships.

Through all of the testimony and my due diligence, I remain 100% convinced that NON-WAGE income was not to include draws and personal income of owners. The confusion came about from a section in the 2012 tax bill which was thought to allow working capital in a business to pass through tax free so the money could be reinvested back into the business to expand and create jobs. The now famous tag line "Eliminating individual income tax on Non-Wage business income as reported by LLC's, S-Corps, and Sole Proprietorships on lines 12, 17, and 18 of the federal form 1040 individual income tax return" created the loophole language. These thirty one (31) words created the language that allows 333,792 business owners, sole proprietors, S-Corps, and farmers to treat their personal income as "non-wage" income and pay zero personal income taxes. All other taxpayers, approximately 1.8 million, pay an effective tax rate of about 2.93% on their personal incomes. 1.8 million tax filers pay reduced Kansas state income tax rates on brackets of 2.7% and 4.6% consistent with the 2012 tax reduction legislation - while 333,792 tax filers are 100% tax exempt entirely - they pay a ZERO income taxes on their personal Income.

Here is a table that illustrates my understanding of the legislative intent of the original tax bill.

Small Business Scenario	Prior Tax Policy	Loop Hole Current Policy	Adjust to Legislative Intent
Revenue	$ 150,000	$ 150,000	$ 150,000
Expenses Before Owner Pay	$ 70,000	$ 70,000	$ 70,000
Preliminary Profit	**$ 80,000**	**$ 80,000**	**$ 80,000**
Owner Withdrawals:			
Less: Owner withdrawals, Salary, etc.	$ 50,000	$ 50,000	$ 50,000
Working Capital	$ 30,000	$ 30,000	$ 30,000
Tax on Owner's Salary	$ 2,400	$0	$ 2,400
Tax on Working Capital	$ 1,440	$0	$0
Total Tax	$ 3,840	$0.00	$ 2,400
Effective Tax Rate	**4.80%**	**0.00%**	**3.00%**

The number of entities utilizing the exemption grows larger every year. In 2012 it was 191,000. By 2015 it had already grown to 333,792 and will get bigger each year. Every time the number grows it means another tax filer is coming off the tax rolls and paying zero taxes. The total exemption has caused at least a $250 million annual loss to the state treasury and continues to make the budget unstable. My own calculations of state tax collections of payroll tax and business income shows significant shortfalls from original projections from which we made the tax policy change on. My calculations reflect on annual and ongoing shortfall of $205 million. The pass through exemption has never performed up to its original expectations.

Modifying the pass through income exemption is a correction to reflect legislative intent. I know it was not my intent, nor the majority of fellow legislators I have discussed this with, to allow business owners, sole proprietors, S-Corps, and farmers to treat their personal income as "NON-WAGE" income and pay zero personal income taxes. Instead, the legislative intent was to lower the tax rate on these entities to provide additional working capital to grow their businesses and create jobs. In fact, prospectively it is estimated that the majority of the pass though entities have no employees. **Some estimates show 85% of the pass through entities having no employees and paying no income tax on personal earnings.** If that same data would have been presented during original testimony, it would have been clear that wages were not going to be taxed and in my opinion the loophole would have never been created.

Everyone uses State services, so everyone should pay state income taxes. The 333,792 exempt filers should not be singled out to pay zero state taxes.

Respectfully,

Jim Denning

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Kansas State Senate – District 8