Testimony to House Taxation Committee
HB 2023 Eliminating Income Tax Exemption on Pass-Through Income
January 19, 2017
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Chairman Johnson and Members of the Committee,

We appreciate this opportunity to present testimony in opposition to HB 2023, which would eliminate the income tax exemption on pass-through income for businesses organized as sub-S corporations, partnerships, proprietorships and limited liability corporations that elect to be taxed as individuals.

The rationale for this legislation has been stated as a fairness issue and we agree that exempting certain taxpayers from income tax creates is a legitimate fairness issue. Indeed, in our 2012 testimony, we said the ideal way to do tax reform was to simply reduce marginal rates for all taxpayers and not change any deductions, exemptions or credits. But we stand in opposition to HB 2023 for several reasons.

Fairness

If fairness is the justification, then we encourage the Committee to simultaneously attempt to resolve all of the unfair measure in the tax code; to do otherwise can be seen by citizens as endorsing all other unfair taxation issues.

Pass-through entities are not the first to be fully or partially exempt from state income tax; that distinction goes to government retirees. State and local KPERS retirees pay income tax on their personal contributions but their pension payments are not taxed, which means they are exempt from tax on the majority of their pension income which is provided by employer contributions and the earnings on those contributions. Data provided by KPERS shows that someone retired from USD 512 Shawnee Mission in 2015 with a lump sum payment of $854,571 and will receive annual payments of $59,543 for life and never pay a penny of state income tax on that income while living in Kansas. How is that fair to the private citizens who are fully taxed on their pension or 401(k) payments?

Legislators who participate in KPERS get an even better deal than other state employees; their income is inflated to assume they worked a full year rather than 90 days, but that fairness issue isn't on the table.

The Board of Regents confirms that "benefits-eligible faculty and staff at KBOR state universities and the KBOR office participate in the mandatory 403(b) retirement plan. Employee contributions are pre-tax and... withdrawals are not subject to Kansas tax." Legislators and others have said it's not fair that a proprietor doesn't have pay income tax while his or her employees are taxed on their pay. In the absence of legislation attempting to deal with KPERS and Regents' income tax exemptions, the clear message to private sector citizens is that legislators believe government employees deserve better treatment.

The State of Kansas' HPIP program exempts businesses selected by government from sales tax and provides income tax credits. The PEAK program allows businesses chosen by government to keep 95 percent of their eligible employees' state income tax withholding for up to 10 years. Not addressing these and other taxpayer subsidies to preferred businesses in this legislation undermines the claim that HB 2023 is about fairness.

The Legislature allows local government to exempt chosen businesses from state and local sales tax with the use of STAR bonds, Community Improvement Districts and Industrial Revenue Bonds, which results in others being taxed more to make up the difference.

The Legislature provides sales tax exemptions to a wide array business activities, services, retail purchases and many non-profit organizations (for the record, KPI pays sales tax) totaling more than $5 billion dollars annually. Some of the exempt entities even came to the Legislature one at a time asking for special treatment.

Unfairness is even baked into the State Constitution. For example, owners of commercial and industrial real estate are charged 2.2 times the effective tax rate of residential real estate because their property is taxed at 25 percent of appraised value while homeowners are taxed at 11.5 percent of appraised value.

And how exactly is it fair to retroactively tax people who have already made plans and investments in their businesses based on existing tax law?

Economic Impact

Reversing the exemption on pass-through income will negatively impact economic growth and job creation. Extracting money from the private sector will always have a negative impact on private economic growth; every new dollar paid in tax is a dollar not available for investment or hiring. Some claim that pass-through entities didn't create any jobs because the average tax savings isn't enough to hire anyone, but no such assumption can be made from a business's taxable income as taxable income is merely what is left over after expenses for hiring and investments.

To the contrary, U.S. Census data shows that 82 percent of new jobs in 2013 and 2014 came from pass-through businesses; 2015 data has not yet been published. The County Business Database tracks employment by legal form of organization at the state level since 2010 and shows a remarkable change in the growth of pass-through employment relative to C-Corporation employment since the pass-through exemption went into effect.

Kansas Employment by Legal Entity Type							
Entity Type	Number of Employees on March 12			2010-12 Change		2012-14 Change	
	2010	2012	2014	# Jobs	Percent	# Jobs	Percent
Corporations	535,839	530,567	537,948	(5,272)	-1.0%	7,381	1.4%
Pass-Through	418,544	428,593	464,728	10,049	2.4%	36,135	8.4%
Non-profits	143,726	143,815	145,355	89	0.1%	1,540	1.1%
Other	10,834	11,788	10,994	954	8.8%	(794)	-6.7%
Private	1,108,943	1,114,763	1,159,025	5,820	0.5%	44,262	4.0%
Source: U.S. Census, County Business Patterns database							

Pass-through entities (businesses not organized as C-corporations) added 36,135 jobs and grew by 8.4 percent compared to C-corporation growth of just 1.4 percent and 7,381 jobs. Some of the pass-through job additions are attributable to C-corporations that converted to pass-through status but most likely fewer than the number of new proprietors added, which aren't included in the Census database; their employment data is provided by the Bureau of Labor Statistics which excludes proprietors and farm workers.[1]

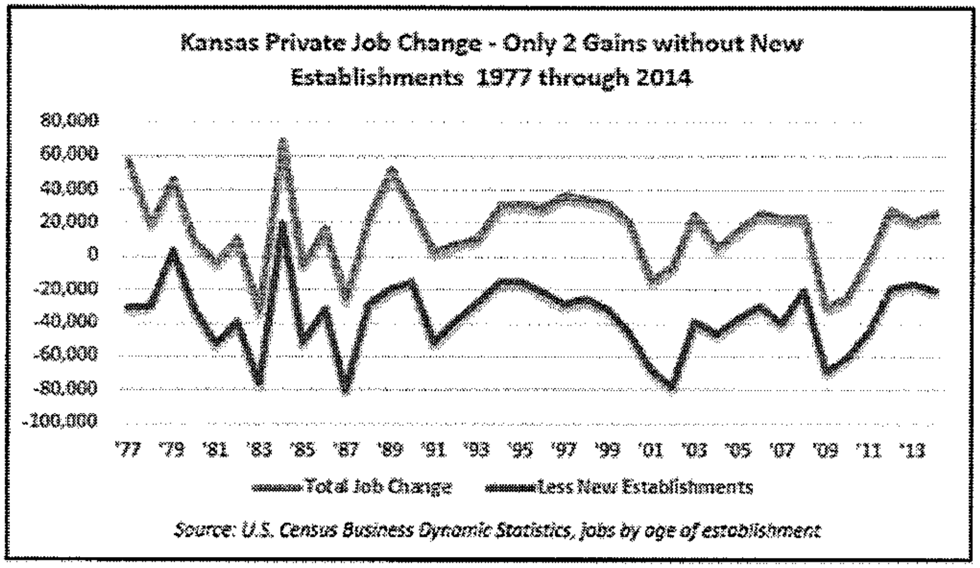
The Kansas Department of Revenue reports that only 3.3 percent of C-corporations converted and the total number of W2s for all C-corporations declined by 10,396. Even if every W2 decline resulted from a conversion, the job transfer would still be less than the 15,134 new proprietors reported by the Bureau of Economic Analysis.[2]

Kansas' pass-through job growth rate of 8.4 percent is slightly lower than the national average of 9.5 percent but much more competitive than before tax reform, being at 88 percent of the national average (8.4 percent compared to 9.5 percent) versus 52 percent (2.4 percent compared to 4.6 percent).

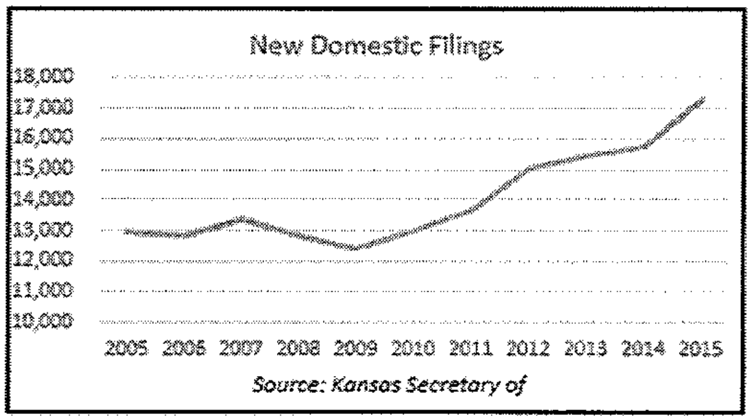
U.S. Employment by Legal Entity Type							
Entity Type	Thousands of Employees on March 12			2010-12 Change		2012-14 Change	
	2010	2012	2014	# Jobs	Percent	# Jobs	Percent
Corporations	51,829	53,510	53,961	1,681	3.2%	450	0.8%
Pass-Through	43,387	45,374	49,697	1,987	4.6%	4,323	9.5%
Non-profits	15,020	15,238	15,591	218	1.5%	353	2.3%
Other	532	530	539	(3)	-0.5%	10	1.8%
Private	110,768	114,652	119,788	3,884	3.5%	5,137	4.5%
Source: U.S. Census, County Business Patterns database							

There is no way of knowing how many of the new pass-through jobs were created solely because of the pass-through exemption but we do know that the rate of growth jumped significantly after implementation of the exemption and C-Corporation employment grew much slower. We also know that job creation from the formation of new establishments is essential to the Kansas economy.

As explained in A Thousand Flowers Blooming – Understanding Job Growth and the Kansas Tax Reforms, "Job growth is critically dependent on new business formation. Several studies have found that start-ups and young firms drive overall job creation.[3] A key academic study found that "firm births contributed substantially to both gross and net job creation."[4] To see how this has played out over time in Kansas, [the chart below] shows the trend of total job creation and jobs created excluding those created by new establishments from 1977 through 2014, the most current data available from the Census Bureau.



Census defines an establishment as "a single physical location where business is conducted or where services or industrial operations are performed;" they define a firm as "a business organization consisting of one or more domestic establishments that were specified under common ownership or control, with the firm and the establishment being the same for single-establishment firms."[5] For example, new establishments could be a new bio-tech startup, a proprietor opening a new restaurant or even a new Walmart location. In Kansas, with the exception of 1979 and 1984, the total number of jobs created would actually have been negative if not for the job creation from new establishments."



Some of the jobs from new establishments come from C-Corporations but given the recent disparate growth for pass-through jobs and the record number of new business filings from Kansans, it's reasonable to expect that pass-through business filings and employment will be negatively impacted by an unnecessary $200+ million tax increase on those businesses.

And how is it fair to the people who will likely lose their job or have fewer employment opportunities as a result of this unnecessary $200 million+ tax increase?

State Budget

The net tax generated from removing the exemption on pass-through income, reinstating the credits previously provided to those businesses including taxes paid to other states and the tax loss carryover would generate a little over $200 million – or about 3 percent of General Fund spending. Given that Kansas spent 27 percent more per-resident than states without an income tax in 2015 while providing the same basket of services, we believe the budget can be balanced without this or any other tax increase.[6] The Alvarez and Marsal efficiency study also found $2 billion in potential savings over a four-year period even though the study did cover all of state government.

If fairness is the really the issue, one would reasonably expect HB 2023 to reduce other taxes with the revenue generated by eliminating the exemption on pass-through income.

Conclusion

Since HB 2023 ignores all other fairness issues and the budget can be balanced without tax increases that would be harmful to job creation, passing this legislation would perhaps inaccurately tell Kansans that legislators don't really care about fairness or the economic impact. That surely is not the message intended to be sent by this legislation and we encourage you to oppose HB 2023 as currently written.

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[1] A small number of proprietors listed in the Census database are IRS designations, which says it treats LLCs "...as either a corporation, partnership, or as part of the LLC's owner's tax return (a "disregarded entity"). Specifically, a domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it files Form 8832 and affirmatively elects to be treated as a corporation. And an LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 and affirmatively elects to be treated as a corporation." https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc

[2] BEA report of new proprietors per SA25N downloaded November 28, 2016

[3] For a review of this literature, see Stephen J. Davis, John Haltiwanger, and Ron Jarmin, "Turmoil and Growth: Young Businesses, Economic Churning, and Productivity Gains," Ewing Marion Kauffman Foundation, June 2008, available at: http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2008/06/turmoilandgrowth060208.pdf

[4] John Haltiwanger, Ron S. Jarmin, and Javier Miranda. "Who Creates Jobs? Small Versus Large Versus Young," *The Review of Economics and Statistics*, Vol. XCV, No. 2, May 2013, available at: http://www.mitpressjournals.org/doi/pdf/10.1162/REST_a_00288

[5] http://www.census.gov/ces/dataproducts/bds/definitions.html

[6] National Association of State Budget Officers, U.S. Census; federal spending and expenditures related to issuance of new debt are excluded.