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Impact of KY IIT Rate Reductions On Tax Increment Financing Districts

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HB 8 - 2022 Regular Session

- During the 2022 Regular Session, the General Assembly adopted House Bill 8 (“HB8”). HB8 implemented a two-tiered formulaic approach which would reduce the Commonwealth’s Individual Income Tax (“IIT”) rate by 0.5% each time both of the two fiscal yearend financial tests were met by the Commonwealth’s General Fund.

- The Commonwealth’s General Fund met both of these tests for fiscal years 2021 and 2022. This resulted in the Commonwealth’s IIT rate being reduced from 5.0% to 4.5% for calendar/tax year 2023, and then from 4.5% to 4.0% for calendar/tax year 2024.

- An unintended consequence of these IIT rate reductions was the negative impact they would have on existing TIF districts around the Commonwealth that receive IIT increment rebates each year.

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Increment Calculation Formula

- Prior to 2023, for each calendar year during the active life of a TIF the formula below was used to calculate the rebated tax increment for each participated tax type (ex. Individual Income Tax "IIT")

ADD: New Revenues (Gross Tax Revenues within Footprint)

LESS: Old Revenues (Baseline Year Taxes grown by CPI annually)

Incremental Tax Revenue

X Participation % (generally 80% or less)

= Rebated Tax Increment

Impact of IIT Rate Reduction – No Baseline

- Looking at a hypothetical TIF with $1 million of net annual taxable wages and a baseline of $0, each 0.5% IIT rate reduction results in a 10% decrease to the rebated IIT increment (vs 5% IIT rate)

Net Taxable Wages	$1,000,000	$1,000,000
IIT Rate	5.0%	4.5%
New Revenues	$ 50,000	$ 45,000
Old Revenues	$ -	$ -
Total Increment	$ 50,000	$ 45,000
X Participation %	80%	80%
Rebated Increment	$ 40,000	$ 36,000
% Reduction		10%

Impact of IIT Rate Reduction – Baseline #1

- Using the same hypothetical TIF, if we now assume a Baseline > $0, each 0.5% IIT rate reduction results in a >10% decrease to the rebated IIT increment (higher the baseline, higher the % reduction)

Net Taxable Wages	$1,000,000	$1,000,000
IIT Rate	5.0%	4.5%
New Revenues	$ 50,000	$ 45,000
Old Revenues	$ 10,000	$ 10,000
Total Increment	$ 40,000	$ 35,000
X Participation %	80%	80%
Rebated Increment	$ 32,000	$ 28,000
% Reduction		13%

Impact of IIT Rate Reduction – Baseline #2

- Using the same hypothetical TIF, if we now assume a Baseline > $0, each 0.5% IIT rate reduction results in a >10% decrease to the rebated IIT increment (higher the baseline, higher the % reduction)

Net Taxable Wages	$1,000,000	$1,000,000
IIT Rate	5.0%	4.5%
New Revenues	$ 50,000	$ 45,000
Old Revenues	$ 20,000	$ 20,000
Total Increment	$ 30,000	$ 25,000
X Participation %	80%	80%
Rebated Increment	$ 24,000	$ 20,000
% Reduction		17%

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Formula Analysis

- In 2022, in consultation with several of our TIF recipient clients, Commonwealth Economics ("CE") analyzed several variations to the basic increment calculation formula (from slide 3). This included adjustments to Old Revenues, Participation %, and an extension of the TIF term, as well as combinations of these variables.

- None of these combinations produced a viable or acceptable solution that could fully mitigate the impact of IIT rate reductions on the rebated increment amounts of all previously approved TIFs.

- Alternatively, CE developed a strategy which would fully mitigate the negative impacts of IIT rate reductions.

- This strategy involved a simple adjustment to the definition of New Revenues in the increment calculation formula while leaving the rest of the formula and process as is.

Modified New Revenues

- Beginning with calendar/tax year 2023, there would be an adjustment to New Revenues as part of the IIT increment calculation.

- After the New Revenues amount has been determined by the Department of Revenue, this amount would be multiplied by a "Modifier" equal to 5% divided by the IIT rate for the calendar/tax year being calculated (ex. 5%/4.5% for 2023).

- The result would be a Modified New Revenues amount which would be equivalent to the tax revenues were the IIT rate still at 5%.

- The Modified New Revenues would take the place of New Revenues in the increment calculation formula for the IIT.

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Modified Revenues Formula

- Under this strategy, the increment calculation formula for IIT is modified by replacing New Revenues with Modified New Revenues (defined as New Revenues X modifier of 5%/IIT rate).

ADD:	Modified New Revenues
LESS:	<u>Old Revenues (Baseline Year Taxes grown by CPI annually)</u>
	Incremental Tax Revenue
X	<u>Participation % (generally 80% or less)</u>
=	Rebated Tax Increment

Modified Revenues – Illustration

- Under this strategy, the increment calculation formula for IIT is modified by replacing New Revenues with Modified New Revenues. See examples below.

Net Taxable Wages	$1,000,000	$1,000,000	$1,000,000	$1,000,000
IIT Rate	5.0%	4.5%	4.0%	3.5%
New Revenues	$ 50,000	$ 45,000	$ 40,000	$ 35,000
Modifier (5%/IIT Rate)	1.0000	1.1111	1.2500	1.4286
Modified New Revenues	$ 50,000	$ 50,000	$ 50,000	$ 50,000
Old Revenues	$ -	$ -	$ -	$ -
Total Increment	$ 50,000	$ 50,000	$ 50,000	$ 50,000
X Participation %	80%	80%	80%	80%
Rebated Increment	$ 40,000	$ 40,000	$ 40,000	$ 40,000
% Reduction		0%	0%	0%

Additional Legislation

- During the 2023 Regular Session, the General Assembly adopted House Bill 360 ("HB 360") which implemented this Modified New Revenues approach for calculating IIT increments. However, under HB 360, it was only adopted for calendar years 2023 and 2024.

- During the 2024 Regular Session, the General Assembly adopted House Bill 8 ("2024 HB8"). 2024 HB8 extended the adoption period for the Modified New Revenues approach through calendar/tax year 2026.

Real World Impact Level

- Using 2022 actual IIT increment results for 10 of the active TIF districts, the calculations below illustrate the impact of reducing the IIT rate in 2023 on TIFs around the Commonwealth had the Modified New Revenues formula not been adopted.

	2022 Actual (5%)	2023 Estimated (4.5%)
New Revenues	$ 16,964,581	$ 15,268,123
LESS: Old Revenues	$ 9,900,573	$ 9,900,573
Incremental Revenues	$ 7,064,009	$ 5,367,551
X Participation %	Varies	Varies
Rebated Increment	$ 5,631,274	$ 4,276,290
$ Reduction		$ 1,354,984
% Reduction		24.1%

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Additional Discussion Points

- Since the Modified Revenues language has only been authorized through 2026, there remains significant risk to our existing TIF districts were the IIT rate to be reduced further after 2026.

- To fully mitigate the impacts of IIT rate reductions on existing TIF districts, this Modified New Revenues approach needs to be made permanent.

- If the IIT rate were ever reduced to 0%, the "Modifier" could no longer be calculated and an alternative approach would need to be developed to mitigate this.

- The current law applies only to state TIFs approved by the Kentucky Economic Development Finance Authority ("KEDFA") prior to 2023. Therefore, state TIFs approved after 2022 are still at risk from the impacts of further IIT rate reductions.

Questions?

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