BOURBON BARREL TAXATION TASK FORCE

Minutes of the 2nd Meeting
of the 2022 Interim

July 22, 2022

Call to Order and Roll Call

The 2nd meeting of the Bourbon Barrel Taxation Task Force was held on Friday, July 22, 2022, at 10:00 AM, in Room 169 of the Capitol Annex. Senator Robert Stivers, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Robert Stivers, Co-Chair; Representative Chad McCoy, Co-Chair; Senators Denise Harper Angel, Jimmy Higdon, and Christian McDaniel; Representatives Thomas Huff and Cherlynn Stevenson.

Guests: Jennifer Rowe, Senate majority budget staff; Chris Nolan and Jack Mazurak, Kentucky Distillers Association (KDA); Jennifer Hays, Appropriations and Revenue Committee Staff Administrator

LRC Staff: Katy Jenkins, Sarah Watts, Hope Rowlett, and Ashton Thompson

Minutes for June 24, 2022

Upon motion and second, the minutes for the June 24, 2022, meeting were approved without objection.

Information Requested at Last Meeting

Jennifer Rowe, Senate budget majority staff, discussed the responses received to a question which Representative McCoy posed during the last meeting. She was asked to review estimates provided from the first task force meeting and any gains or losses that counties, cities, and various taxing districts may experience if the bourbon barrel tax were repealed and that property were to be removed from the property tax rolls.

Ms. Rowe testified that the Kentucky distillers provided a document during the last meeting which shows projected, estimated gains and losses for all affected parties. The Kentucky Association of Counties (KACO), the Kentucky League of Cities (KLC), the Kentucky School Board Association (KSBA), and the Jefferson County Public Schools (JCPS) reviewed the information and responded to the estimates. All parties agreed with the numbers provided, except there were some conflicts related to the net loss to certain individual school districts. The comparison of the Kentucky Distillers' Association calculations versus the Kentucky Department of Education calculations showed a difference of about $700,000 related to the net loss of certain school districts. The KDE calculation was included in the member's packets. There may be many reasons for the differences between the two calculations, with the main reason being the tier one calculation which can change over time. When a tier one change occurs, it may impact the SEEK calculation for several districts. Also, the school district assessments from the distillers include the certified assessment for school districts, and may also include county or city assessments.

Ms. Rowe testified that there were follow-up questions that need to be addressed, going forward. One question is about what happens to the compensating tax rate calculations if the distilled spirit taxes are removed from the property tax rolls.

Ms. Rowe stated a second question to consider is whether the action to remove this property from the property tax rolls in these few counties would impact the overall SEEK calculation for the remaining counties. The SEEK calculation is based on the total assessment for all school districts. If the total assessment increases or decreases, a state-wide equalization for all districts may occur, impacting all 171 districts.

In response to a question from Senator Stivers, Ms. Rowe agreed that the school districts have a safety net with a backfill through the SEEK allotment, but the other taxing districts do not have that safety net. Related to the compensating rate, if the tax on distilled spirits were to be repealed and that property was removed as taxable property, it would impact what the local school board could do on their compensating rate or go above that and have a referendum vote.

Ms. Rowe clarified that the Nelson County school district number is going to be $4 million. The difference between the KDE and KDA estimates is related to the aggregation of the city and county amounts within the KDA estimates.

In response to a question from Rep. Stevenson, Ms. Rowe explained that Eric Kennedy, as well as representatives from other groups, wanted to come to this meeting, but had scheduling conflicts.

In response to a question from Senator Higdon, Ms. Rowe agreed that the chart included in the meeting materials shows a loss of revenue for Nelson County School District is $6.28 million, but they get back from SEEK $4.3 million for a difference of about $2 million dollars. The city of Bardstown and the other cities would lose up $121,000; the county, $1.1 million; the extension service, $85,000; the library district, $581,000; and the fire district, $7,000.

The distiller's estimates were presented at the last meeting as a fairly comprehensive revenue estimate of the potential loss being backfilled by SEEK. The cities, counties, and other taxing districts do not have the safety net of SEEK and would experience a net loss in revenues if the barrel tax revenues were lost. The distiller’s estimates were reviewed by the interested parties, and is fairly accurate. Nelson County has two systems: Bardstown Independent and the Nelson County system. The $6 million of total tax receipts for the county includes both the independent city system and the county system. It is not broken down between the two.

2022 State of the Distilled Spirits Industry and Taxation

Chris Nolan and Jack Mazurack, with KDA, testified why this task force is necessary. Mr. Nolan stated that the information for the task force isn't only about eliminating a tax and taking away local revenues. It is about looking at the health of the industry as well. The barrel tax is a significant issue for which a solution needs to be found.

The KDA represents 78 members, including 73 distilling operations in 40 counties. The KDA wants to strengthen Kentucky's title as the one, true, and authentic home for bourbon and distilled spirits.

In response to a question from Senator Stivers, Mr. Mazurack believes that the industry is in the middle of the $5.2 billion building boom, with $3.3 billion of that coming in the next few years and these numbers to do include any projections from distilleries which are not members of KDA. These projected expansions would increase the property tax base.

Mr. Nolan testified that the distillery industry is paying $33 million in barrel taxes today, whereas in 2009 that number was $10.7 million. Distilling far outpaced growth in the Commonwealth over a ten-year period. Unlike a farmer or an auto manufacturer, the distilling industry needs the General Assembly’s help to grow. The Bourbon Trail is an example of how growth has occurred with the General Assembly’s assistance. Unfortunately, there remains prohibition-era laws, written some 90 years ago, and we are now in a completely different world.

Mr. Nolan testified that the distilling industry in Kentucky includes seven different taxes on every bottle of spirits and 60 percent of every bottle of spirits goes to tax. Kentucky taxes on both on volume and value of product, and is the only jurisdiction in the world that taxes aging spirits. Other states tax their wine industries at some of the lowest rates in the nation in order to grow the industries. Wine sales have been declining over the last couple of years, but the tourism associated with the wine industry has not. The Bourbon Trail could be similar, even after the bourbon boom reaches its peak.

Exports are the new frontier and fueling growth in the distilled spirits industry. From 1997 to 2017, there were no tariffs. When tariffs were imposed by both the European Union and the United Kingdom, exports dropped by nearly one half, having a huge hit to the industry. Today, Kentucky bourbon is under threat of competition by tequila. Agave-based spirits have surpassed both rum and bourbon in sales. There are almost 2,300 craft distilleries, with most other states having more than Kentucky. With bourbon booming, barriers to entry decreasing across the nation, and craft distillers thriving, the 95% share for Kentucky's bourbon production is starting to drop, as bourbon distillers pop up nationwide.

Mr. Nolan continued that the biggest issue is competition, not only from lower taxation in other states, but also from the white spirits industry, such as tequila and rum. While there are now 10 million barrels of bourbon aging in Kentucky and they are being taxed, that may not always be the case. Bourbon may feel intrinsically connected to Kentucky, but it doesn't have to come from Kentucky, as long as it is made in the United States. Other states are actively marketing against Kentucky when it comes to bourbon manufacturing and production and have quickly adapted and changed their laws, adding privileges and reducing fees to attract the next generation of distillers. HB 500 from this past session allows Kentucky to keep up with these states, but more needs to be done. Jobs are not coming to Kentucky at the rate they're going to other states. For instance, Tennessee is trying to lure Kentucky distillers across the border, Tennessee has no state income tax, and no barrel tax. Tennessee's spirits tax rate is 70 percent lower than Kentucky's rate.

Mr. Nolan testified that to remain competitive the barrel tax should be refundable or eliminate it; Kentucky should reduce distilling's overall tax burden and provide parity with beer and wine in this state; create a competitive ready to drink (RTD) tax rate; and continue to remove regulatory obstacles that restrict growth.

Mr. Nolan testified that the barrel tax is the ad valorem property taxes at the state and local level. The barrel tax is a discriminatory tax that no other jurisdiction levies. It is a product of the administration from decades ago and from court cases that have determined that after two years a barrel in a warehouse is a finished good. The barrel tax credit was established in 2014, when the General Assembly made the policy decision to refund the barrel taxes. The bourbon barrel tax reinvestment credit was created. Initially the tax credit was working well, and distilleries were reinvesting in our properties. Now, there aren't enough credits available to offset the rising barrel taxes. Some distilleries are getting only a small percentage on the dollar. The credits carry forward, but are accumulating at a rate that the industry never be able to realize or to monetize.

The industry asks that the General Assembly remove the barrel tax, as it is a barrier to entry for new distillers wanting to establish their operations in Kentucky. Other states are whittling away the thought that bourbon must be made in Kentucky. By welcoming start-up facilities and taking advantage of the market preference for Kentucky bourbon will increase the number of counties and communities with distilleries, create new jobs, and increase property tax values. The signs indicate that this boom is going to slow, and when it slows, and more distilleries start going to other states, Kentucky will miss out.

The industry wants to be collaborative with our local communities and find a way to get rid of the barrel tax or make it refundable in a way that it's not a barrier for the next generation of distilleries that want to come to Kentucky. The industry wants to make sure that it can nurture that next new distillery that wants to come to Kentucky, but they have to come to Kentucky first.

Mr. Nolan testified that bourbon provides a return on investment (ROI) on the tax revenue to the state and local governments. Revenue has increased from $107 million dollars in 2009 to $286 million in 2021. That is going to primarily the state, so returning the barrel tax of $33 million this year or in 20 years is a great ROI to grow those overall numbers.

In response to Senator Higdon’s question regarding barriers to entry, Mr. Nolan stated that in order to preserve local revenues, the simplest way to implement a change would be to allow the distillers to pay the locals the taxes, and the state would then reimburse the distillers for that payment. Local communities would need to determine how SEEK would backfill a big chunk of it. What leftover monies are not covered would be determined and see how to make local government whole.

In response to a statement by Senator Higdon, Mr. Nolan replied that if some changes in industry aren’t made, the number of barrels aging in the state will not continue to grow. Distillers will start going to other states. There is concern that Kentucky will lose its signature status if changes are not made. The number of barrels might go up to 35 or 40 million in the coming years, but it will start to decline and could decline significantly.

Mr. Mazurak stated that he spoke with a contract distiller in the state, which works for many brands. Those brands, which eventually want their own home place in which to distill, say that they’ll find a state other than Kentucky when it comes to establishing, due to the barrel tax. Mr. Nolan stated that the most attractive state right now to buy juice in the open market to create a label if you’re not distilling it yourself is Tennessee. They buy the juice down there, and they're putting a label on it calling it bourbon.

In response to a question posed by Senator Stivers, Mr. Nolan stated that if bourbon were distilled here, and then moved to another state immediately, he didn’t believe it could be called Kentucky bourbon. He thinks it has to be aged at least one year in Kentucky to have the label Kentucky bourbon on the bottle, but would need to check the statute to be sure. Theoretically, you could distill it, age it one year here, move it, and then not pay the barrel tax anymore and label it as Kentucky bourbon.

In response to another question from Senator Stivers, Mr. Nolan replied that he would need to consult with Dr. Paul Coomes, who drafts their impact statement, to determine if the industry could show the increased property values and increased receipts of occupational taxes to the localities, municipalities, and taxing districts since 2014. Most of the distillers' tax data is proprietary, and probably isn't broken out by industry sector when it is collected. From the state perspective, the economic impact equals approximately $286 million in 2021. That number includes the barrel tax numbers, the wholesale taxes, excise taxes, and everything else collected that the state receives. Mr. Nolan stated that Mr. Coomes has projected the amount of additional economic impact that the bourbon industry will have on local communities, with something around $55 million of economic growth.

In response to a question by Representative Stevenson, Mr. Nolan testified that he does not know exactly where we are in the bourbon boom. Trade wars and tariffs have had a big impact on bourbon, because that's the new frontier. A lot of the growth in aging barrels is due to projecting sales in new markets like Australia, the Pacific Rim, or China. The tariffs put a halt to those growth projections. The tariffs cause major exporting companies to lose tens of millions of dollars each quarter. The tariffs have been removed, and there is hope that recovery happens in foreign countries. If the boom starts slowing, we will see the 10 million barrels drop to 9 to 8 to 7 million barrels. As we start selling that product and not replacing it as quickly, our local tax base in this barrel tax and then employment would start to shrink because we won't be running multiple shifts, seven days a week.

Mr. Mazurak added, in an additional response to Representative Stevenson's question, that we should also look at tourism and The Bourbon Trail attendance which has grown every year since it was established, with the exception of 2020. People are coming from across the United States and across the world to rural areas of Kentucky. Mr. Nolan testified that ready to drink cocktails are known as RTDs. There are malt-based, wine-based, and spirits-based RTDs and a mix of those. Malt-based RTDs have come to Kentucky, but not as many spirit-based RTDs because Kentucky has a high tax rate. If it is under a certain percentage, Mr. Nolan stated that it should all be taxed the same way, regardless of whether it's a malt-base or a spirit-base.

Discussion of Property Tax on Distilled Spirits, Including Constitutional Provisions and Court Cases

Jennifer Hays, Committee Staff Administrator for the Appropriations and Revenue Committee, discussed the provisions of the constitution relating to property taxes, as well as cases that are specifically related to the property tax on distilled spirits.

Ms. Hays discussed three basic provisions in the Constitution: property shall not be exempt from taxation; property shall be assessed at fair cash value; and property shall be taxed according to that fair cash value. Sections 3, 172 and 174 govern this matter. There is an exception in Section 170 of the Constitution, which provides that the General Assembly may provide by law an exemption for all or any portion of the property tax for any class of personal property.

There are at least two cases that point to the fact that the courts have ruled that distilled spirits are personal property. The first is the National Distillers Prod. V. Board of Education, 256 S.W.2d 481 (Ky. Ct. App. 1953). In it, it was established that distilled spirits are like all other changeable personal property situated within the Commonwealth, and therefore subject to the same statutory and constitutional requirements which govern the taxation of such property. The second case is Yount vs. Calvert, 826 S.W.2d 833 (Ky. Ct. App. 1992). In it, it was established that distilled spirits are tangible personal property subject to the same statutory and constitutional requirements which govern taxation of such property.

In response to a question posed by Representative McCoy, Ms. Hays stated that the General Assembly has changed the rate for distilled spirits property tax. The normal personal property state rate is 45 cents. Distilled spirits are assessed today at five cents per $100 of value.

With there being no further business, the meeting was adjourned at 11:37 a.m.