

# **TASK FORCE ON TAX EXPENDITURES**

## **Minutes of the 2nd Meeting of the 2018 Interim**

**July 26, 2018**

### **Call to Order and Roll Call**

The 2nd meeting of the Task Force on Tax Expenditures was held on Thursday, July 26, 2018, at 10:00 AM, in Room 154 of the Capitol Annex. Senator Christian McDaniel, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Christian McDaniel, Co-Chair; Representative Ken Fleming, Co-Chair; Senators David P. Givens, Morgan McGarvey, and Dennis Parrett; Representatives Jason Petrie, Jim Wayne, and Susan Westrom.

Guests: John E. Chilton, State Budget Director; Daniel P. Bork, Commissioner, Department of Revenue; Greg Harkenrider, Deputy Executive Director, Office of State Budget Director; Jennifer Hays, Committee Staff Administrator, LRC Appropriations and Revenue Committee.

LRC Staff: Jennifer Hays, Amit Shanker, Katy Jenkins, Micah Johnson, and Chase O'Dell.

### **Top 10 Tax Expenditures and Bottom 5 Percent Tax Expenditures**

John E. Chilton, State Budget Director; Daniel P. Bork, Commissioner, Department of Revenue; Greg Harkenrider, Deputy Executive Director, Office of State Budget Director; and Jennifer Hays, Committee Staff Administrator, LRC Appropriations and Revenue Committee, testified on the top 10 tax expenditures and the bottom 5 percent tax expenditures.

Six of the top ten tax expenditures by amount are sales and use tax exemptions. Two of the top ten are related to individual income tax. One is related to real property tax, and another is related to corporation income tax.

Director Chilton testified that eliminating prescription drug, food, residential, and standard deduction tax exemptions would be regressive. Director Chilton said expanding the standard deduction might be preferable as an offset to some of the other eliminations that might prove regressive in nature.

Director Chilton stated that policy makers should consider the impacts of taxation on market distortions. Market distortions within Kentucky are sensitive to border effects. More than half of people living in Kentucky live in counties that border other states. None of the states that border Kentucky tax pharmaceuticals with prescriptions.

Jennifer Hays testified that prescription drugs, prosthetic devices, and physical aids are tax exempt. All of the tax exempt medical items are defined in statute. Kentucky's definitions are the same definitions that are in the streamlined sales and use tax agreement (SSUTA). A decision to change a defined term would be a violation of SSUTA and would jeopardize Kentucky's participation going forward.

In response to a question from Representative Wayne, Director Chilton said he believes that no state that has a sales tax also taxes prescription drugs.

Food and food ingredients are tax exempt. Alcoholic beverages, prepared food, tobacco, candy, dietary supplements, and soft drinks are exceptions to the tax exemption. Greg Harkenrider testified that it would be easy to administer a tax on food and food ingredients. Mr. Harkenrider went on to say a food and food ingredients tax would probably be regressive.

In response to a question from Representative Westrom, Commissioner Bork explained that the purpose of SSUTA is to have standard definitions across states so that businesses can identify what is and is not taxable. Commissioner Bork went on to explain that SSUTA assists companies in complying with state laws.

In response to a question from Senator Givens, Jennifer Hays said that Kentucky changes its statutes each time the Streamlined Governing Board changes a definition in SSUTA.

In response to a question from Representative Fleming, Greg Harkenrider stated that the Consensus Forecasting Group looks at the trends of prepared foods as well as the trends of everything else in the sales tax base. Mr. Harkenrider also said that prepared food consumption as a percentage of total food consumption has been rising for years. In response to another question from Representative Fleming, Commissioner Bork testified that it is not difficult for the state to administer a food tax, but that it is more difficult for national retailers to comply with the tax rates of different states.

In response to a question from Senator McGarvey, Greg Harkenrider stated that the Office of State Budget Director (OSBD) has information regarding the population of Kentuckians living on a border in each county.

In response to a question from Senator Givens, Commissioner Bork said Streamline will play a major role in the compliance of online retailers to the Wayfair decision.

Jennifer Hays testified that charitable, religious, and educational organizations are exempt under KRS 139.495. The exemption only applies to entities that have received tax exempt status from the Internal Revenue Service under Section 501(c)(3) of the Internal Revenue Code. Only sales to a 501(c)(3) entity are exempt – and only when that purchase is used within the educational, charitable, or religious function of the organization. Sales made by these entities are not exempt. However, per KRS 139.496, all non-profit organizations are exempt from sales tax on the first \$1,000 of sales per year. Commissioner Bork testified that the elimination of tax exemptions for charitable organizations would discourage the formation of exempt organizations and raise the cost of education and other charitable services.

In response to a question from Representative Wayne, Commissioner Bork stated that he was not aware of other states taxing charitable organizations. Director Chilton clarified that the administration was not recommending the elimination or upholding of any tax expenditures.

Residential utilities are exempt from sales tax in Kentucky. Greg Harkenrider said 32 other states either have a sales tax or a utilities gross receipts tax on residential utilities.

In response to a question from Senator McGarvey, Greg Harkenrider stated that in the 32 states that tax residential utilities, it is not generally the case that they use a scale to administer different tax rates based on income. Commissioner Bork added that it would be difficult to administer such a practice.

Sales to any cabinet, department, bureau, commission, board, or other statutory or constitutional agency of the state are tax exempt. Sales to counties, cities, or special districts are also tax exempt. This tax exemption only applies to purchases for use solely in the government function. Director Chilton testified that taxing sales to government entities would have a budgetary impact that would be adverse to the entities.

Various livestock, feed, seeds, and fertilizers are exempt from sales and use tax. Greg Harkenrider reported that elimination of the tax expenditure on various livestock, feed, seeds, and fertilizers would adversely affect farming communities.

In response to a question from Senator Givens, Commissioner Bork said he believed it would not be difficult to qualify a farmer, but he believed qualifying the goods sold and what they will be used for would be much more difficult.

In response to a question from Representative Wayne, Commissioner Bork stated that a lot of states have agricultural exemptions of some kind. In response to a follow-up question from Representative Wayne, Commissioner Bork explained that giving tax breaks

on the annual filing of taxes would be easier administratively for the Department of Revenue, but more difficult for farmers.

Jennifer Hays testified that an individual may elect to itemize their deductions or take a standard deduction. Commissioner Bork stated that House Bill 487 eliminated most itemized deductions. Commissioner Bork testified that raising the standard deduction would help low income individuals.

Social Security benefits taxed at the federal level are exempt for Kentucky income tax. Director Chilton explained that more states tax retirement benefits than tax social security benefits. However, 13 states tax social security benefits.

The state tax rate on real property is reduced to compensate for any increase in the aggregate assessed value of real property to the extent that the increase exceeds the preceding year's assessment by more than four percent. Greg Harkenrider testified that the state real property tax yearly revenue ceiling had a tax expenditure of \$506,100,000 in FY 18. Mr. Harkenrider explained that the tax expenditure is so high because eliminating it would increase the current rate of 12.2 cents to 31.5 cents.

In response to a question from Representative Petrie, Jennifer Hays stated that the four percent cap has not had a function since 2009 other than to possibly limit the growth in property tax receipts. Director Chilton stated that the cap protects tax-payers from enormous increases in property tax when the value of their home increases.

Dividend income received by a corporation has been exempt since December 31, 1969. Commissioner Bork said the corporate dividend income tax expenditure was put into place to avoid double taxation of corporate dividends.

In response to a question from Representative Wayne, Commissioner Bork said there are a few states that tax corporate dividends.

Jennifer Hays testified that 160 of the bottom five percent of tax expenditures had a cost of less than \$1 million each. Jennifer Hays continued to say that another 64 tax expenditures from the bottom five percent ranged in cost from \$1 million to \$11.9 million annually each.

Forty-two tax expenditures, ranging in cost between \$12.2 million and \$120.8 million annually, make up the gap between the top 10 and the bottom five percent of tax expenditures.

In response to a question from Sen. McGarvey, Jennifer Hays clarified that each of the 42 tax expenditures between the top 10 and the bottom five percent range in cost from \$12.2 million to \$120.8 million annually.

In response to another question from Senator McGarvey, Greg Harkenrider stated that roughly \$600 million would be earned per each one percentage point increase in the state sales tax.

In response to a question from Senator McDaniel, Commissioner Bork explained that tax expenditures listed with zero impact are often old tax expenditures that were meant for a specific purpose that is no longer relevant. In some cases, there are very few taxpayers that take advantage, or that can take advantage because of the definition of the rules.

In response to a question from Senator McDaniel, Greg Harkenrider explained that the OSBD was unable to substantiate the exact cost of the Film Industry Tax Credit because all of the applications had not yet been processed at the time of the completion of the tax expenditure report.

Jennifer Hays said the limited liability entity tax has minimum and reduced rates for small businesses. A business making less than \$3 million in gross receipts pays a minimum rate and a business making between \$3 million and \$6 million pays a graduated rate.

Jennifer Hays testified that it would be difficult for the Department of Revenue to administer an occasional sales tax because it would be required to enforce the tax on every individual that makes a single sale in a year.

Representative Wayne expressed his desire for the Task Force on Tax Expenditures to make a recommendation to the 2019 General Assembly to add a sunset clause when creating new exemptions, and requiring research to justify the reestablishment of any new exemption preceding its sunset.

Representative Petrie expressed his agreement with Representative Wayne and his surprise that there are no sunset provisions for past exemptions. Representative Petrie also stated his desire for all of the tax expenditures to be brought before the legislature when making the budget each biennium.

In response to a question from Representative Fleming, Commissioner Bork stated that the use tax is intended to tax equipment and business assets in the state they are used. In response to a follow up question from Representative Fleming, Commissioner Bork stated that individuals typically pay taxes on an item where they buy it, whereas businesses pay taxes on an item where they use it.

With no further business before the committee, the meeting was adjourned.