COMMONWEALTH OF KENTUCKY STATE FISCAL NOTE STATEMENT
LEGISLATIVE RESEARCH COMMISSION
2015 REGULAR SESSION

MEASURE

2015 BR NUMBER **0844** **HOUSE** BILL NUMBER **132**

RESOLUTION NUMBER_____ AMENDMENT NUMBER _____

SUBJECT/TITLE An ACT relating to taxation.

SPONSOR Representative Jim Wayne

NOTE SUMMARY

FISCAL ANALYSIS: ☒ IMPACT ☐ NO IMPACT ☐ INDETERMINABLE IMPACT

LEVEL(S) OF IMPACT: ☒ STATE ☐ LOCAL ☐ FEDERAL

BUDGET UNIT(S) IMPACT: **Revenues**

FUND(S) IMPACT: ☒ GENERAL ☒ ROAD ☐ FEDERAL ☐ RESTRICTED AGENCY _____ ☐ OTHER

FISCAL SUMMARY

FISCAL ESTIMATES	2014-2015	2015-2016	ANNUAL IMPACT AT FULL IMPLEMENTATION
REVENUES		$174M (GF) $23M (RF)	$540M (GF) $36M (RF)
EXPENDITURES			
NET EFFECT		$174M (GF) $23M (RF)	$540M (GF) $36M (RF)

( ) indicates a decrease/negative

MEASURE'S PURPOSE:

This is a comprehensive tax reform proposal. It would:

- Change the individual income tax rates;
- Cap itemized deductions at $17,500;
- Lower the excludable amount of the pension exclusion, and phase out the pension exclusion as income increases;
- Provide for a Kentucky earned income tax credit;
- Remove the Domestic Production Activities Deduction;
- Implement a 'throwback' rule for apportionment of income;
- Require 'combined' reporting for corporations;
- Lower the Limited Liability Entity Tax exclusion threshold;
- Disallow any "tax haven" arrangements that move income to offshore locations;
- Make the film industry tax credit non-refundable;
- Reinstate the Kentucky estate tax by 'decoupling' from the federal estate tax;

- Clarify the use of agricultural valuation on inherited property;
- Adjust the motor fuels tax rate floor price;
- Reduce dealer compensation for collection of motor fuels taxes;
- Make the property tax rate for real property 12.2 cents per $100 value, remove adjustment provision;
- Remove the recall provision for real property tax rate adjustments;
- Change requirements to report rental space for RV's, boats, and aircraft;
- Amend the property tax exemption for personal property shipped out of state;
- Remove the distilled spirits case tax;
- Increase the tobacco tax, include rolling papers and e-cigarettes;
- Require a review and sunset of economic development tax credits;
- Impose the sales tax on a number of services.

PROVISIONS/MECHANICS:

Income Taxes:

Various sections of KRS Chapter 141 would be amended or created to provide for the income tax amendments.

For individuals:

- The income tax rate brackets would be expanded, with a new top rate of 6.5% imposed on taxable income over $150,000.
- Itemized deductions that currently are determined in a manner similar to what is allowed on the federal return would be limited or capped at $17,500. Amounts that exceed $17,500 would not be deductible.
- The pension exclusion would be reduced to $35,000, and the exclusion would be phased out as income increases above $35,000.
- A Kentucky earned income tax credit that equals 15% of the federal credit would be allowed.

For businesses:

- The limited liability entity tax exclusion and phase out would be reduced to an exclusion of $1 million of receipts, with a phase out of the exclusion from $1 million to $2 million of receipts.
- The Domestic Production Activity Deduction is a calculated amount, and is up to 9% of domestic activity on the federal return. Currently, Kentucky allows up to 6% as a deduction. This change would remove the deduction entirely for Kentucky purposes.
- Interrelated corporate entities would be required to file as a combined group.
- Multistate businesses that apportion income would be required to report to Kentucky certain income that is not taxed in other states.
- The film industry tax credit would no longer be refundable.
- Transactions that would cause income to be reported in a "tax haven" location would be ignored in determining taxable income.

Estate Taxes:
Kentucky estate tax law would revert to the federal law in effect on January 1, 2003, with limits on the amount of the unified credit that may be used to reduce a taxable estate. The bill would reinstate Kentucky's estate tax to the amount that would have been due if federal changes that occurred after 2003 were not recognized.

Inheritance Tax:
Agricultural value would be allowed as the method of determining estate values for inheritance and estate taxes for the spouse and descendants of a decedent, if the beneficiaries agree to maintain agricultural use of the property for a specified time.

Motor Fuels Taxes:
- Establish the minimum value on which the motor fuels tax will be calculated as $2.616 per gallon.
- Reduce the dealer compensation for motor fuels taxes from 2.25% to 1% of tax due.

Property Taxes:
- Remove the annual adjustment to real property tax rates and set the property tax rate at 12.2 cents per $100 of value.
- Remove the voter recall provision for a real property tax rate that results in a revenue increase of more than 4%, apply the same change to all local property tax rate increases.
- Require that a business providing rental space to RV's, mobile/manufactured homes, boats, and aircraft to report the rental arrangements.
- Clarify that personal property that is exempted from assessment because of being shipped out of state must be permanently shipped out of state.

Distilled Spirits:
Remove the distilled spirits case tax.

Tobacco and Cigarette Taxes:
- Increase the tax on cigarettes from a combined rate of 60 cents per pack to a rate of $1.60 per pack, for a net increase of one dollar per pack.
- Increase the tax on snuff, chewing tobacco, and all other tobacco products in an amount proportionate to the increase in cigarettes.
- Include e-cigarettes as a tobacco product subject to the tax.

Economic Development Tax Credits:
Require a study and evaluation of all current economic development credits, and provide a systematic sunset on the granting of any additional credits. After the expiration date of a credit, additional credits may be granted only with express action of the General Assembly.

Sales Tax:
Extend the sales and use tax to a group of services.

FISCAL EXPLANATION:

Income Taxes:
The changes to the income tax brackets result in a decrease in tax liability for lower income taxpayers (and the lower part of taxable income for higher income taxpayers) and an increase in tax liability for higher income taxpayers. The top bracket rate of 6.5% is a rate increase of 0.5% for taxable income over $150,000.

The cap on itemized deductions will affect a significant number of Kentucky filers. More than 90% of Kentucky filers with income above $75,000 itemize their income tax deductions. This change would allow each taxpayer to deduct the first $17,500 of itemized deductions, and would disallow all itemized deductions that exceed that amount.

The pension income exclusion currently allows up to $41,110 of pension income to be received tax free (more for a civil service retiree with service credit applicable to pre-1998 employment). This change would reduce the exclusion to $35,000 and would then phase-out that exclusion for anyone with income exceeding $35,000 and up to $70,000. A person with income exceeding $70,000 would no longer have a retirement income exclusion.

The federal earned income tax credit is a refundable credit that a filer with earned income (usually W-2 wages, but also includes self employment income) can receive. The credit is targeted to workers who also have children, but a married couple with no children can receive a small credit. A taxpayer or couple with three or more children can qualify for over $6,000 in refundable credits, depending on their level of income. This proposal would create a Kentucky credit that would be equal to 15% of the federal credit amount.

For businesses, the federal government allows a created deduction for the amount of production costs that a business incurs for activities conducted within the United States. This deduction is to encourage production activities to be conducted at sites within the US. The federal deduction is equal to 9% of the actual domestic production costs incurred. The Kentucky deduction currently allowed is equal to 6% of those same costs. This proposal would no longer allow the “Domestic Production Activities Deduction” as a Kentucky business deduction.

Kentucky based businesses that operate in a multistate environment follow specific guidelines to determine how to allocate their income between the various states. Some income may be assigned to a state where there is no income tax, and accordingly not be taxed by any state. Several states have a “throwback” rule where any income that is not taxed in any other state is taxed in the home state of the business. Kentucky does not have that provision, this change would implement a “throwback” rule for Kentucky.

Under current law, Kentucky corporations are required to consolidate their business filings based on levels of common ownership. A consolidated group will file a single return for multiple corporate entities, based on the level of common ownership. The businesses may have no functional coherence, and may be unrelated in any area except common ownership. This proposal would instead cause a business group to file a common return as a common entity based on the unitary nature of the business. A business that functions as a unified entity for business purposes would also file as a single common entity for tax purposes, in order to more accurately report its business activity and taxable income.

Businesses, and individuals that report business income, are currently able to take advantage of multi-level business structures to assign otherwise taxable income to foreign countries where the business would owe a reduced rate of tax, or no tax at all. There are several structures that accomplish this goal. One example would be to sell or assign intellectual property such as patents, trade names, or copyrights to a foreign subsidiary, then pay rents or royalties to the foreign subsidiary that holds the intellectual property. This structure would effectively move taxable income from the domestic entity where the income is generated to the foreign entity where the intellectual property is held. The proposal in this bill would disallow or significantly restrict the use of structures such as the method illustrated above to move taxable income offshore to no-tax or low-tax “havens”.

The Limited Liability Entity Tax (LLET) is assessed against gross receipts or gross profits of Kentucky businesses. An exemption exists for the first $3 million of gross receipts or gross income, and that exemption phases out from $3 million to $6 million of receipts/gross income. This proposal would reduce that exclusion from $3 million to $1 million, and reduce the phase out of $3 million/$6 million to a phase out range of $1 million to $2 million of gross receipts / gross income

Kentucky currently allows a tax credit for various kinds of films or motion pictures that are produced within Kentucky. The credit is limited to $5 million each year, and is fully refundable. This proposal would change that credit from refundable to non-refundable, meaning that a taxpayer who is awarded this credit would receive no benefit from the credit if they had no Kentucky tax liability.

Estate taxes:
Kentucky’s estate tax prior to 2003 was equal to the amount that the federal government allowed as a tax credit on the federal estate tax return for an estate tax assessed by any state. The amount of the state tax was deducted dollar-for-dollar from the federal tax due. Beginning in 2003, the federal credit was reduced and eliminated, and the Kentucky estate tax, which was equal to the amount of the allowed federal credit, was also reduced and eliminated. This proposal would reinstate the Kentucky estate tax to the level prior to the federal law change that eliminated the Kentucky estate tax.

Inheritance tax:
Real property that is assessed at agricultural value would be valued at the agricultural value for inheritance tax purposes, if the heir was a qualified family member and continued to use the property for a qualified agricultural purpose for 5 years after inheriting the property.

Sales tax:
A significant number of services are specifically identified and would become subject to the sales tax under this bill. Kentucky’s sales and use tax is generally only assessed against the sale of tangible personal property, this change would extend the sales tax to a group of services.

Property tax:
Since the passage of House Bill 44 in 1979, the state tax rate on real property has trended downward due to the limit put into place by HB 44 that kept state property tax revenues from growing by more than 4% per year unless additional steps are taken. As property values increased, the tax rate was reduced to keep annual growth in expected revenues at or below 4%. The rate has been reduced from 35 cents per $100 value in 1979 to 12.2 cents per $100 value currently. This bill would fix the rate now and going forward at 12.2 cents, and stop any further rate reductions from automatically occurring.

Boats, RV's, aircraft, and other similar mobile property are often difficult to assess and tax for property tax purposes. The property can be relocated, and the PVA of the county where the property moves to may not be aware of its presence. Moving property has become a way to cause the property to not be assessed for property tax purposes. This bill would require that businesses leasing or renting space to boats, RV's, aircraft, etc., to provide the PVA or the Department of Revenue with a listing of all property occupying rental space.

Distilled Spirits Case Tax:
This tax generates very little revenue and is duplicative of other alcohol taxes. The proposal would remove this tax.

Tobacco taxes:
The proposal would increase cigarette taxes by $1.00 per pack, and increase the various other categories of tobacco products by a proportional amount. A floor stocks tax would be implemented to capture the increase on all inventories of unsold products. E-cigarettes would become taxable as are other kinds of tobacco products.

Road Fund taxes:
The average wholesale price (AWP) of motor fuels, which is used to calculate the per-gallon tax rate for motor fuels, is defined as a measured wholesale price taken from a survey of prices conducted each quarter. The tax rate is equal to 9% of the average wholesale price, but the AWP cannot increase over the previous year's AWP by more than 10%. If the surveyed AWP increases, the AWP used to determine the motor fuels tax rate may not rise as high as the surveyed rate. Conversely, as the surveyed rate declines, the AWP calculation also declines. The statute contains a "floor" below which the AWP for tax purposes cannot go. That rate would be increased in this bill from $1.786 to $2.616 per gallon.

The estimated change in motor fuels tax revenue is based on the difference in the minimum value that would be established by this bill and the expected value from the current consensus forecast budget estimate. That estimate may be significantly different from current pump prices and actual wholesale values.

Vendors who transport and wholesale motor fuels are allowed to keep a portion of the tax collected as compensation for handling and remitting the tax. The current compensation rate is 2.25% of the tax collected. This bill would reduce that amount to 1%.

Estimates of the dollar impact of many of the changes made in this bill are difficult. To the extent the changes are to an existing tax or are similar to an existing system of taxation, the estimates are based on how changes to that existing tax structure or system would be expected to impact revenue from that tax. When the proposal involves a change that is more difficult to measure, other factors were utilized to try and estimate the revenue impact.

Estimated Fiscal Impacts (Amounts in Millions)	**FYE '15**	**FYE '16**	**FYE '17**	**Full Impl.**
Income Tax:				
Itemized Deduction Cap:		35	200	200
Lower/Phase out Retirement Exclusion:		38	220	220
Refundable Earned Income Tax Credit:			-115	-115
Tax Rate structure changes and new top rate:			-110	-110
Throwback apportionment recapture:			16	16
Combined reporting requirement:			25	25
Disallowance of "tax haven" transactions:			25	25
Limited Liability Entity Tax exclusion change:			13	13
Domestic Production Activities Deduction:			4	4
Film industry tax credit non-refundable:			5	5
Estate taxes:			8	25
Sales and Use tax inclusion of selected services:		50	115	115
Property taxes				
Real Property rate at 12.2 cents				
Reporting of rental space – RV's, boats, aircraft:			3	3
Distilled spirits case tax:		-1	-1	-1
Tobacco taxes:				
Cigarettes		60	100	100
Other tobacco products		6	10	10
E-cigarettes		3	5	5
Fiscal Estimate Total - General Fund:		**174**	**523**	**540**
Road Fund:				
Raise floor for Average Wholesale Price		7	15	15
Decrease vendor compensation from 2.25% to 1%		16	21	21
Fiscal Estimate Total -- Road Fund:		**23**	**36**	**36**

DATA SOURCE(S): **OSBD, DOR, IRS, LRC Staff, ITEP**
PREPARER: **John Scott** **NOTE NUMBER**: **2** **REVIEW**: **GMR** **DATE**: **1/7/2015**