

**COMMONWEALTH OF KENTUCKY STATE FISCAL NOTE STATEMENT
LEGISLATIVE RESEARCH COMMISSION
2016 REGULAR SESSION**

MEASURE

2016 BR NUMBER **1256**

BILL NUMBER **HB 342**

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: _____

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

FISCAL SUMMARY

FISCAL ESTIMATES	2015-2016	2016-2017	2017-2018	ANNUAL IMPACT AT FULL IMPLEMENTATION
REVENUES		\$263 M (GF) \$8 M (RF)	\$553 M (GF) \$9 M (RF)	\$570 M (GF) \$9 M (RF)
EXPENDITURES		Indeterminable	Indeterminable	Indeterminable
NET EFFECT		\$263 M (GF) \$8 M (RF)	\$553 M (GF) \$9 M (RF)	\$570 M (GF) \$9 M (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;
- Allow the use of agricultural valuation on inherited property;

- Reduce dealer compensation for collection of motor fuels taxes;
- Set the property tax rate for real property at the current rate of 12.2 cents per \$100 value, remove adjustment provision;
- Remove the recall provision for real property tax rate adjustments;
- Recapture reporting of rental space for RV's, boats, and aircraft for property tax purposes;
- Amend the property tax exemption for personal property shipped out of state;
- Repeal the distilled spirits case tax;
- Increase the cigarette tax and tobacco products tax;
- Require a review and sunset of economic development tax credits; and
- 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 eliminated.
- 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:

- 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 the current rate of 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:

- Repeal 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 \$1.00 per pack.
- Increase the tax on snuff, chewing tobacco, and all other types of 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 an additional 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 that income is not 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.

Currently, businesses, and individuals that report business income, are 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 effectively moves taxable income from the domestic entity where the income is generated to the foreign entity where the intellectual property is held. This proposal 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 between \$3 million and \$6 million of gross receipts/income. This proposal reduces the exemption to \$1 million, from the current \$3 million exemption, and readjusts the phase out range to receipts/income between \$1 million and \$2 million.

Kentucky currently allows a tax credit for various kinds of films or motion pictures that are produced within Kentucky. 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, after subtracting any inheritance tax paid. The amount of federal credit was based on the size of the estate and unrelated to the eventual tax due. Because of the tax structure, Kentucky’s estate tax was commonly called the “pick-up” tax because our tax merely picked up the difference between the federal credit and Kentucky’s inheritance tax. Beginning in 2003, the federal credit was phased-out to zero. The result of this congressional action was that the Kentucky estate tax was also reduced to zero. This proposal reinstates the Kentucky estate tax as if the federal tax credit provisions had not been phased out and at the federal credit amounts prior to the federal law change.

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.

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 types of 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. This bill would require that businesses leasing or renting space to boats, RV's, aircraft provide the PVA or the Department of Revenue with a listing of all property occupying rental space so that this property may be properly assessed for state and local property tax.

Distilled Spirits Case Tax:

This tax generates very little revenue and is duplicative of other alcohol taxes. The proposal would repeal 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:

Motor fuels dealers are allowed to keep a portion of the tax due as compensation for remitting the tax timely. This compensation also is allowed to cover evaporation and shrinkage of the product, unaccountable losses, collection costs, and bad debts. 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.

Additionally, multiple proposals within a tax may be interdependent and are scored based on the other proposals within the tax. Any changes made to the multiple proposals within a tax and any regrouping of separate items must result in the rescoring of the new proposal.

Estimated Fiscal Impacts (Amounts in Millions)	FYE '16	FYE '17	FYE '18	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:		69	104	104
Property taxes				
Real Property rate at 12.2 cents				
Reporting of rental space – RV's, boats, aircraft:			3	3
Distilled spirits case tax:		-0.1	-0.1	-0.1
Tobacco taxes:				
Cigarettes		75	100	100
Other tobacco products		30	36	36
E-cigarettes		16	19	19
Fiscal Estimate Total - General Fund:		262.9	552.9	569.9
Road Fund:				
Decrease vendor compensation from 2.25% to 1%		8	9	9
Fiscal Estimate Total -- Road Fund:		8	9	9

DATA SOURCE(S): OSBD, DOR, IRS, LRC Staff

PREPARER: Jennifer Hays NOTE NUMBER: 60 REVIEW: JRS DATE: 2/3/2016