

Kentucky Tax Reform

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Lessons Learned from a Staff Perspective

A Presentation to the Federation of Tax Administrators
October 18, 2016
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Past and Present Efforts in Kentucky



- 2005 Tax Reform – Governor Ernie Fletcher
 - ▣ Primarily Business Tax Reform
 - Repealed Corporate License Tax
 - Changed Nexus Standard
 - Changed Definition of “Corporation” to include pass-through entities
 - Repealed Property Tax on Inventory In-Transit
- 2006 Tax Reform – Governor Ernie Fletcher
 - ▣ Altered the Corporation Tax Reform
 - Repealed “AMC”
 - Implemented LLET (gross receipts tax)
- 2012 Proposed Tax Reform – Governor Steve Beshear
 - ▣ Blue Ribbon Commission on Tax Reform
 - ▣ Voted Out over 100 Proposals
- 20xx – Governor Matt Bevin

Today's Roadmap



- Identify common themes among reform efforts
 - ▣ Not political themes
 - ▣ Themes of certain taxes
 - ▣ Consumption versus income taxation
- Discuss ways to score proposals
 - ▣ Data challenges
 - ▣ Local impacts
- Talk about interactions between discrete scores and the score of the entire proposal
 - ▣ The whole isn't always the sum of the parts
 - ▣ Interactions between discrete elements
- Differentiate between static and dynamic scoring
- Discuss lessons learned

Common Themes Among State Reform



- Move toward single-factor apportionment
- Market based sourcing (sales other than the sale of tangible products)
- Taxation of services
- Individual income tax reform
 - ▣ Move to consumption-based
 - ▣ Reducing the rate down in phases
 - ▣ Base broadening
- Need to broaden base in the sales tax
- Narrow the property tax base

Handout Caveats



- The handout represents a portion of the work of the Blue-Ribbon Commission's recommendations – some did not clear the political filter
- This proposal was heard in the House but died before a final vote
- Revenue positive rather than neutral
- Scores are static, not dynamic
- We scored at least 100 more proposals that failed to make the final cut

Reduce Individual Income Tax Rates

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- ❑ Reduces the top rate from 6% to 5.9%
- ❑ Reduces the number of tax brackets from six to four
 - ❑ Old rate brackets were in effect since 1960
 - ❑ Added a small change in 2005, but virtually unchanged since inception
- ❑ Will include a hold harmless provision to ensure that no taxpayers see rate increases due to the consolidation of the rate brackets
- ❑ Fiscal Impact upon full implementation: -\$180.1 Million

Proposed Income Tax Rate Schedule

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Current Rate Structure		Proposed Rate Structure		
AGI	Current Rate	AGI	Number of Filers	Proposed Rate
\$0-\$3,000	2%	\$10,000 or less	555,322	4%
\$3,001-\$4,000	3%			
\$4,001-\$5,000	4%			
\$5,001-\$8,000	5%			
\$8,001-\$75,000	5.8%			
\$75,001 and over	6%	\$10,00 to \$50,000	868,326	5.5%
		\$50,000 to \$100,000	306,219	5.75%
		Over \$100,000	128,052	5.9%

Alternative Proposal (Cost \$-168 million)

Current Rate Brackets

For taxable income ...	Current Rates	Tax Cost
\$3,000 or less	2.0%	\$60 per return
\$3,001 to \$4,000	3.0%	\$30 per return
\$4,001 to \$5,000	4.0%	\$40 per return
\$5,001 to \$8,000	5.0%	\$150 per return
\$8,000 and \$75,000	5.8%	\$3,886 per return
\$75,001 or more	6.0%	---

Proposed Rate Brackets (cost of \$168 million)

For taxable income ...	Proposed Rate	Number of Returns	Percent of Tax Liability
\$10,000 or less	4.0%	555,322	0.2%
\$10,000 to \$50,000	5.5%	868,326	27.1%
\$50,000 to \$100,000	5.75%	306,219	32.1%
\$100,000 or more	5.9%	128,052	40.6%

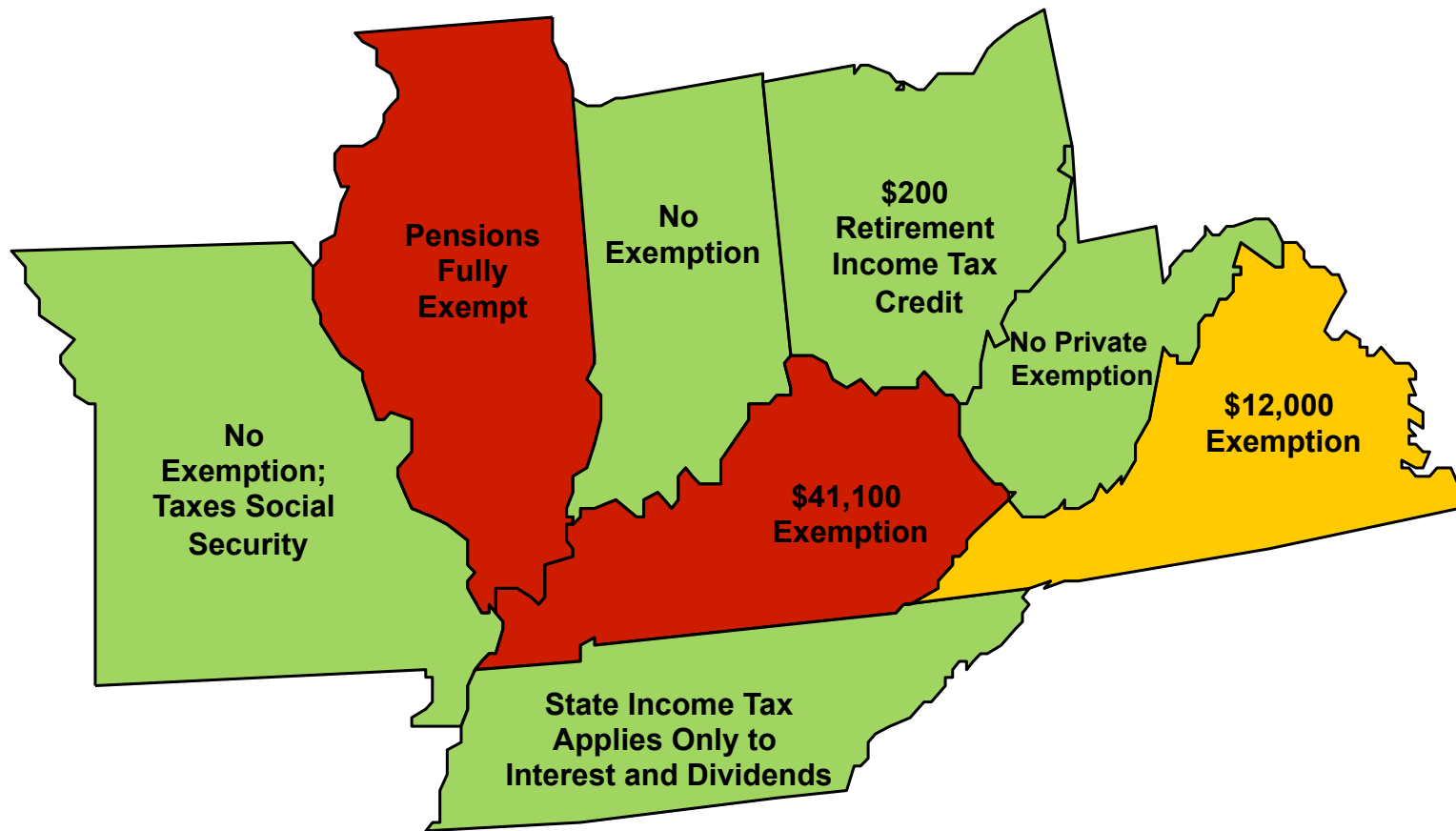
Distributional Impacts (cost of \$168 million)

For taxable income ...	Proposed Rate	Number of returns	Tax Impact
\$10,000 or less	4.0%	555,322	-\$3.9 million
\$10,000 to \$50,000	5.5%	868,326	-\$51.6 million
\$50,000 to \$100,000	5.75%	306,219	-\$64.2 million
\$100,000 or more	5.9%	128,052	-\$48.3 million

Broadening Individual Income Tax Base to Tax Retirement Income

- ❑ Reduce retirement income exclusion for taxpayers with a federal AGI over \$80,000 and phase it out for AGI of \$100,000
- ❑ Only 90,200 filers out of 1.8 million would be impacted by this proposal
- ❑ Social Security benefits are not taxable under current law and would remain untaxed in the future
- ❑ KY has an aging population that continues to use its services
- ❑ Our panel of economists suggested taxation of retirement income as a way to improve elasticity and stabilize revenues

Pension Laws in Surrounding States



Base Broadening through Taxing More Retirement Income

(Various Options for phasing out the exclusion of retirement income)

(\$ million for Fiscal Impacts)

Option	Description	Number of Filers Impacted	Estimated Annual Fiscal Impact (millions)	SSI Taxes	Threshold Basis
1	Retirement Income Phase-out Based on Total Income -- Start phase-out of exclusion at \$50,000 Complete loss at \$70,000	179,630	\$242.9	No	Total \$\$
2	Retirement Income Phase-out Based on Total Income -- Start phase-out of exclusion at \$75,000 Complete loss at \$95,000	95,369	\$199.7	No	Total \$\$
3	Retirement Income Phase-out Based on Total Income -- Start phase-out of exclusion at \$80,000 Complete loss at \$100,000	90,229	\$176.3	No	Total \$\$
3	Retirement Income Phase-out Based on Total Income -- Start phase-out of exclusion at \$100,000 Complete loss at \$120,000	78,253	\$148.3	No	Total \$\$
4	Retirement Income Phase-out Based on Total Income -- Start phase-out of exclusion at \$125,000 Complete loss at \$145,000	36,581	\$95.3	No	Total \$\$
5	Retirement Income Phase-out Based on Total Income -- Start phase-out of exclusion at \$150,000 Complete loss at \$170,000	26,922	\$72.3	No	Total \$\$

Enact a Refundable Earned Income Tax Credit (EITC) at 7.5% of the federal credit

- ❑ Approximately 424,000 Kentucky taxpayers would qualify
- ❑ Average credit would be \$171.50
- ❑ Fiscal Impact upon full implementation: \$72.8 Million
- ❑ Economic benefits include:
 - ❑ Higher disposable income for lower-income Kentuckians
 - ❑ Increased Incentive to join labor force
 - ❑ Increased sales for vendors who depend on in-state consumption for their primary sales base

EITC Availability in Surrounding States



Eliminate the \$10 Personal Credit on the Individual Income Tax Credit

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- Created in 1960 at \$20 and lowered to \$10 in 2013, this tax credit is outdated and unnecessary.
- Tax relief for low-wage earners is currently provided by the Family Size tax credit
- Furthermore, the proposed EITC will also assist low-wage workers
- Fiscal Impact upon full implementation: \$32.8 Million

Require Kentucky filers to use the same income tax filing status that is used on the Federal Income Tax Returns

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- Only 3 other states allow married couples to file separately on a combined return
- 20 states, including three of our border states, require “same as federal” status
- This provision will simplify the filing process
- 430,000 filers would be impacted by this proposal
- Fiscal Impact upon full implementation: \$72.8 Million

Lower the top corporate income tax rate from 6.0 percent to 5.9 percent

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- Will bring Kentucky's rate lower than all surrounding states but one
- Economists recommend states have the same top corporate and individual rates to avoid arbitrary changes in business legal structures

State	Corporate Income Tax
Indiana	8.0%
Illinois	9.5%
Missouri	6.25%
Ohio	0%
Tennessee	6.5%
Virginia	6.0%
West Virginia	7.75%

Fiscal Impact upon full implementation: -\$6.4 Million

Single Factor Apportionment

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- ❑ Currently, Multi-state business apportion the amount of their income that is subject to taxation in Kentucky based on a three-factor formula based on three percentage
 - ❑ Kentucky Sales divided by Total Sales (double-weighted)
 - ❑ Kentucky Payroll divided by Total Payroll
 - ❑ Kentucky Property divided by Total Property

- ❑ The current formula penalizes businesses that have made substantial investments in Kentucky plant operations and Kentucky Payroll

- ❑ By phasing in “single-factor apportionment” we would eliminate that penalty on investing in Kentucky operations and increasing Kentucky Payroll

- ❑ 18 states currently use single factor apportionment. Only two neighboring states (IL, IN) do.

- ❑ Fiscal Impact upon full implementation: -\$154.5 Million

Exempt inventory from state property tax

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- ❑ This proposal exempts certain kinds of inventory from the state's property tax including:
 - ❑ Merchant's inventory,
 - ❑ Manufactured finished goods, and
 - ❑ Good stored in warehouse
- ❑ This proposal was recommended for economic competitiveness
 - ❑ 52% of Kentucky's population lives in a border county
 - ❑ Inventory and goods stored in warehouses are very mobile
- ❑ Fiscal Impact upon full implementation: -\$7.2 Million
- ❑ Does not include any loss to the locals, as the property tax would still be assessed locally.

Exempt classes of property with reduced state rates and no local rates

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- ❑ This proposal seeks to eliminate several taxes on certain classes of property that cost more to collect than they generate in funds.
- ❑ Before the 1998 constitutional change, all property was required to be taxed at fair market value such that sub-classed of property could not be exempted.
- ❑ Thus, various classes of property were given significantly reduced rates
- ❑ The proposal effects:
 - ❑ Manufacturer's raw materials/ goods in process (5 cents per \$100)
 - ❑ Motor Vehicles Held for sale dealers only (5 cents per \$100)
 - ❑ Aircraft: non-commercial (1.5 cents per \$100)
 - ❑ Watercraft: non-commercial (1.5 cents per \$100)
 - ❑ Livestock & Farm Machinery (one-tenth of one cent per \$100)

Fiscal Impact upon full implementation: -\$5 Million

HELP KENTUCKY'S
SIGNATURE
INDUSTRIES THRIVE
AND EXPAND

Create an income tax credit for the bourbon industry to encourage barrel storage

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- This credit must be reinvested in facilities and equipment
- This proposal supports a signature industry while protecting local revenues generated by the property tax
- Reinvestment will create improved competitiveness in the industry
- The Kentucky distilling industry is responsible for a total of 8,690 jobs in the state, but a total annual payroll of \$413 million. It has grown 120% since 1999
- Fiscal Impact upon full implementation: -\$13.3 Million

Exempt the sales and use tax on certain equine products

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- ❑ This proposal extends exemptions that currently exist for other livestock to our signature equine industry
- ❑ Kentucky's signature horse industry has an economic impact of over \$3 billion to the commonwealth annually as well as supporting over 40,000 jobs. This is down significantly from the \$4 billion industry with 100,000 jobs the industry represented just a few years ago.
- ❑ This includes exemptions for hay, feed, feed additives, watering systems, equine grooming supplies, straw, seed, and fertilizer applied to pastures
- ❑ This measure will enhance the competitiveness of a signature industry that has struggled significantly in recent years.
- ❑ Fiscal Impact upon full implementation: -\$14.8 Million

Exempt the sales tax on pharmaceuticals for food animals

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- ❑ This proposal will increase the competitiveness of our agricultural producers
 - ❑ Margins are tight in the sale of food animals
 - ❑ Tight margins have led farmers to purchase medicines out of state

- ❑ Food Animals included are cattle, pigs, hogs, sheep, goats and poultry

- ❑ This exemption not only help farmers but will provide a large incentive for animal pharmaceutical networks to repatriate to Kentucky

- ❑ Half of all states currently exempt pharmaceuticals for livestock, including all of our border states.

- ❑ Fiscal Impact upon full implementation: -\$4.8 Million

Lower the wholesale taxes on beer, wine, and distilled spirits

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- This proposal would lower the current 11% wholesale tax on beer, wine and distilled spirits to 10% over a three year period
- Distilled spirits are the only alcohol subject to a wholesale case excise tax. This proposal would also repeal that tax as a way to bring our tax code into the 21st century
- Fiscal Impact of all reductions upon full implementation: -\$16.1 Million

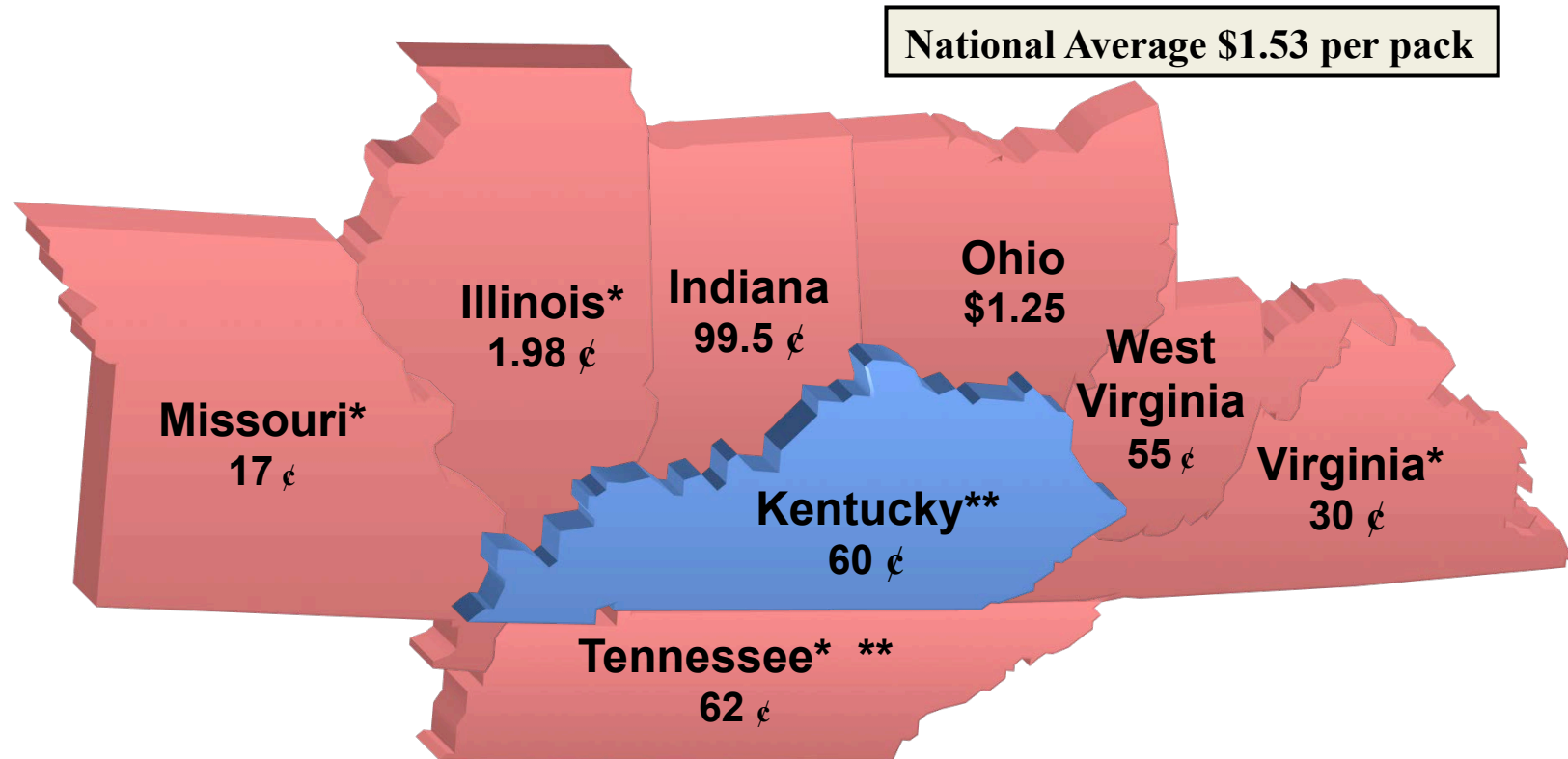
CREATE A HEALTHIER KENTUCKY WORKFORCE TO ATTRACT JOBS

Increase tobacco tax rates

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- Increases the tax on cigarettes from \$0.60 to \$1.00
- Increases the tax on other tobacco products from 15% to 25% of value
- Increases the tax on snuff and chew from 19¢ per tin or pouch to 31.7¢ per unit
- Introduces a tax on e-cigarettes at 20% of wholesale value
- This also includes a restoration of the Cigarette Rolling Papers Tax
- This also includes e-cigarettes, a new nicotine delivery system that has begun to garner a large share of the market, and presents new health challenges.
- These proposals will significantly improve health outcomes for Kentucky
- Fiscal Impact upon full implementation: \$125.3 Million

State excise taxes on cigarettes

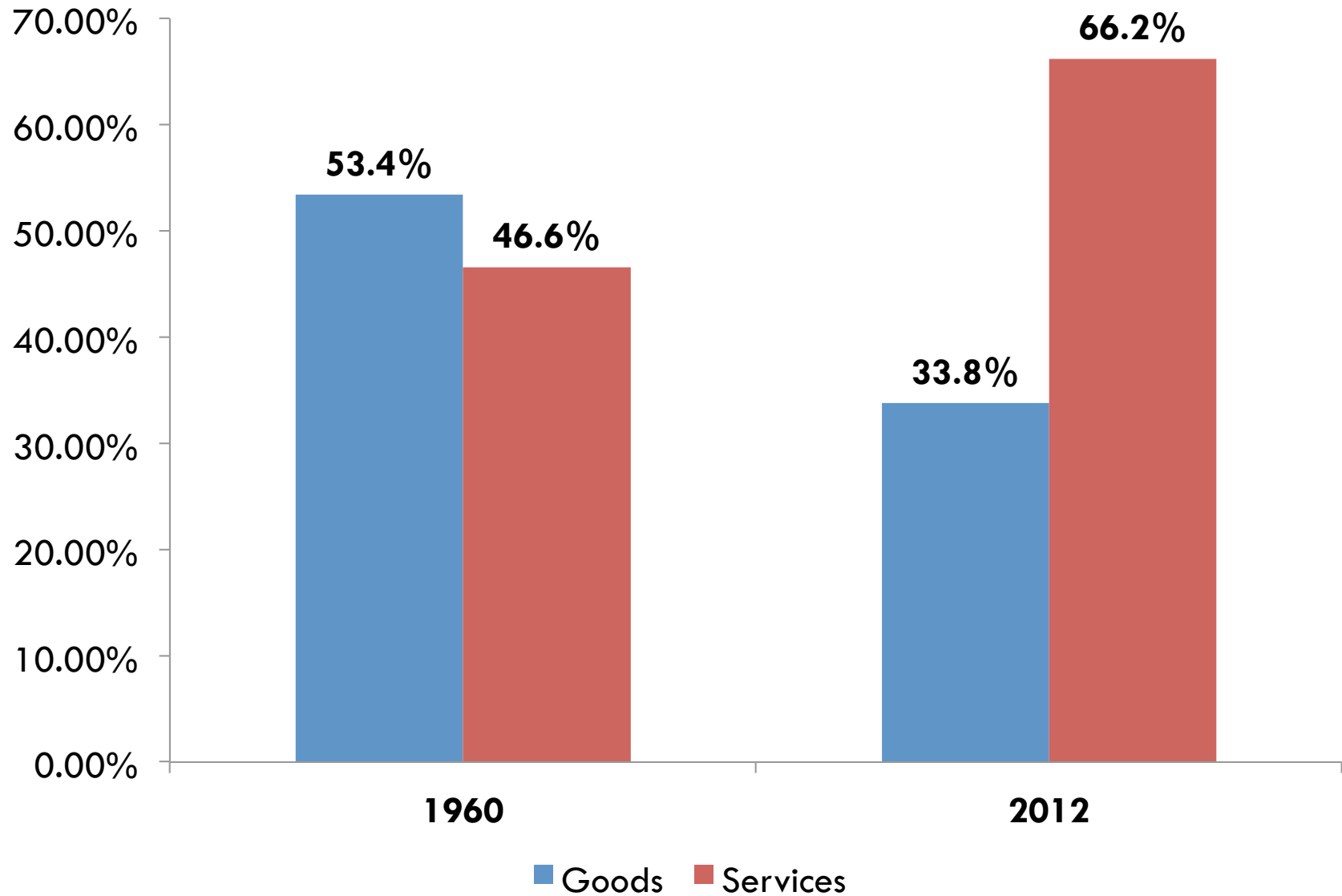


** Dealers pay an additional enforcement and administrative fee of \$0.03 per pack in Kentucky and \$0.05 in Tennessee.

**MODERNIZE CODE TO
ACKNOWLEDGE CHANGES
IN THE ECONOMY &
TECHNOLOGY**

CHANGING ECONOMY - STAGNANT TAX CODE

Consumer Spending Patterns Have Changed



Principles for Sales Tax on Services

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- Look to services that are not portable across state lines
- Look to services that are tied to a taxable tangible good
- Look for service where the service providers are already established with DOR
- Look to services already taxed by other states, recognizing that every state taxes some services.

Broaden the sales tax to include selected services

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- Changes to the sales tax are necessary to prevent the further erosion of the tax base, to remove the structural deficit, and to bring Kentucky's tax code in line with its economy

- This proposal includes recommendations to expand the sales tax to three broad areas of service:
 - Installation, Maintenance and Repair of Taxable Personal Property
 - Admissions and Recreational Activities
 - Limited Commercial, Residential and Personal Services

- Fiscal Impact upon full implementation: \$279.9 Million

Installation, Maintenance and Repair of Taxable Personal Property

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Examples	Full Implementation (millions)	Other States	Contiguous States
<ul style="list-style-type: none"> Installation, repair and maintenance of all taxable machinery and equipment (personal and business) 	\$54.45	24	OH, TN, WV
<ul style="list-style-type: none"> Automotive repair services 	\$45.15	25	OH, TN, WV
<ul style="list-style-type: none"> Other repair services tied to consumer goods 	\$17.09	24	OH, TN, WV
<ul style="list-style-type: none"> Computer software/hardware installation and repair 	\$16.50	23 if installed by seller, 18 if installed by 3rd party	3 if installed by seller, 3 if installed by 3rd party (OH, TN, WV)
<ul style="list-style-type: none"> Labor and repair services on electronics 	\$9.95	24	OH, TN, WV
Subtotal	\$143.14		

Admissions and Recreational Activities

Examples	Full Implementation (millions)	Other States	Contiguous States
• Fitness and recreational sports centers	\$9.24	22	MO, OH, TN, WV
• Golf courses and country clubs	\$8.25	23	MO, OH, TN, WV
• All other amusement and recreation industries	\$6.36	31 (cultural events), 37 (professional sporting events)	MO, TN, WV
• Overnight Trailer Campgrounds	\$5.80	29	IN, MO, TN, VA, WV
• Marina and boat dock slip rental and storage services	\$5.25	18	WV
Subtotal	\$34.90		

Kentucky currently applies the sales tax to the admissions fees at non-participatory recreational activities, such as amusement park entry fees, art exhibits, concerts, cover charges at bars, fairgrounds, movie theatres, museums, nightclubs, sports arenas, state parks and street fairs. This changes would be an expansion to participatory admissions

Limited Commercial, Residential and Personal Services

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Service Category	Full Implementation (millions)	Other States	Contiguous States
• Landscaping services, excluding lawn care	\$25.03	21	IN, OH, WV
• Janitorial services (including carpet, upholstery and window cleaning)	\$21.68	19	OH, WV
• Warranty Service Contracts for taxable property	\$21.61	33	IL, IN, OH, TN, VA, WV
• Industrial Launderers and Linen Supply	\$17.80	33	OH, TN, VA, WV
• Security systems services (except locksmiths)	\$11.20	18	OH, WV
• Pet care (except medical veterinary) services	\$2.64	18	TN, WV
• Tanning Salons	\$1.90	22	MO, OH, TN, WV
Subtotal	\$101.85		

Sales Tax on all Prewritten Software, regardless of method of delivery

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- ❑ This proposal will preserve Kentucky's existing tax base by clarify that prewritten software on digital clouds is still subject to the sales tax
- ❑ At least 14 states tax remote access to software, including IN, OH, WV
- ❑ Proposal was a direct recommendation from the BRTF and represents agreed upon language between providers and the Department of Revenue
- ❑ Fiscal Impact upon full implementation: \$5 Million

Apply sales tax and transient room taxes to the entire hotel accommodation price

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- The advent of online hotel room purchasing has led to an erosion of revenues to state and local governments
- This proposal makes sure that all amounts paid for hotel accommodations, including those charged by online travel companies, are included in the tax base
- This simple change represents yet another example whereby this tax proposal updates our tax code to the changing method of delivery for goods and services
- Fiscal Impact upon full implementation: \$4.7 Million

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