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Kentucky Tax Reform Commission Offers Disappointing Grab Bag

By
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Introduction

Last week, Kentucky's Blue Ribbon Commission on Tax Reform released their final report.[1] The 23-member group, summoned by Gov. Steve Beshear (D) and the twelfth such tax reform study group since 1982, set out to determine how the state tax system could be made more fair, more competitive, more simple, more elastic (grow with the economy), and more adequate (support state services).

If fully enacted, the changes would increase state revenue by $646 million per year. Some of the recommendations are timely and should be implemented, but overall, the report offers a grab-bag of provisions with little central theme. Taken together, the recommendations would raise income and excise taxes, reduce corporate taxes (primarily for select in-state businesses), and maintain a costly business property tax system with few changes. The merits and implications of this approach are not explained in the report let alone defended as the right policy.

Their recommendations for each tax area are listed and analyzed in the following tables.

Individual Income Tax

Table 1: Individual Income Tax Recommendations

Change	Revenue Impact
Modestly reduce rates on income over $4,000 (see Table 2).	-$219 million
Enact an Earned Income Tax Credit (EITC) at 15 percent of the federal EITC.	-$119 million
Cap itemized deductions at $17,500.	+$350 million
Reduce the pension income exclusion from $41,110 to $30,000, with the amount phased out completely for high incomes.	+$485 million
Link the state tax code to the federal tax code as of December 31, 2012 (rather than December 31, 2006), reducing differences between the two codes.	-$26 million
Implement a deduction for 529 savings plan contributions.	-$0.4 million
Cumulative	**+$470 million**

[1] *See Report by the Blue Ribbon Commission on Tax Reform to Governor Steve Beshear* (Dec. 17, 2012), http://ltgovernor.ky.gov/taxreform/Documents/Report/TaxReformCommissionReportFinal.pdf.

Table 2: Current and Proposed Individual Income Tax Rates		
Income	**Current Tax Rate**	**Proposed Tax Rate**
>$0	2.0%	2.0%
>$3,000	3.0%	3.0%
>$4,000	4.0%	3.5%
>$5,000	5.0%	4.5%
>$8,000	5.8%	5.5%
>$75,000	6.0%	5.8%

The brackets at the $3,000, $4,000, and $5,000 levels are archaic, in place since a time when those were middle-income annual salaries.[2] Preserving them serves little purpose; deleting them would amount to a modest across-the-board tax cut with significant savings for low-income households. The commission's proposal to cap itemized deductions is more complex than simply offering a large standardized deduction and precluding itemizing, but the economic and revenue effects will likely be the same. No state presently caps itemized deductions, although many offer only a standard deduction.

The modest rate reductions will get the state's sticker price tax rate below a number of other states, including neighboring Missouri (6 percent) and Ohio (5.925 percent). Coupled with the itemized deduction cap, however, the result would be a revenue increase for the state.

Corporate Income Tax

Table 3: Corporate Income Tax Recommendations	
Change	**Revenue Impact**
Reduce top corporate tax rate from 6.0 percent to 5.8 percent.	-$9 million
Change from a three-factor apportionment formula to a single-sales factor	-$110 million
Change services sourcing from cost-of-performance to destination-sourcing.	-$10 million
Reduce the limited liability tax threshold from $3 million to $1 million.	+$13 million
Decouple from federal U.S. production activities (QPAI).	+$4 million
Add management fees to the corporate tax base.	+$15 million
Establish a new "angel" investment tax credit.	-$3 million
Expand the R&D tax credit to "human capital" but cap it and require oversight.	-$4 million
Add income tax credit for bourbon distillers to offset local property taxes on stored bourbon.	-$12 million
Cumulative	**-$116 million**

[2] The $3,000 and $4,000 brackets and rates date to 1936. The $5,000 bracket and rate dates to 1950.

The state corporate income tax is rapidly becoming extinct as a revenue source, due to (1) states exempting in-state business activity, through targeted tax credits and apportionment formulas, and (2) states being unable, for constitutional and equity reasons, to make up that loss by higher taxes on out-of-state business activity. The compliance and administrative costs likely exceed the revenue collected by state corporate income taxes.

Kentucky raises just 3.6 percent of its state-local tax revenue from the corporate income tax, about the average nationally. That percentage will drop if the commission's recommendations are implemented, again following the national trend.

Sales Tax

Table 4: Sales Tax Recommendations

Change	Revenue Impact
Broaden the sales tax base to select "luxury" services. The "principles" for expansion will be: • Household consumption • Luxury items • Services with a clear nexus to Kentucky • Tied to physical products already taxed • Services with inelastic demand (where it would unlikely to see tax avoidance behavior) • Sensitive to border state sales taxes	Depends on list. Estimates range up to +$176 million
Expand the hotel tax to online travel services.	+$5 million
Exempt mail charges for direct mail.	-$3 million
Support federal legislation to collect sales tax on online sales to Kentucky residents.	Requires federal action; estimated up to +$200 million
Require out-of-state Internet retailers to notify Kentucky consumers about sales or use tax obligation.	+$5 million
Exempt "certain equine products to support the signature equine industry."	-$14 million
Apply sales tax to web-based software purchases.	Unknown
Clarify that "header trailers" are exempt as farm inputs.	None
Apply sales tax to amounts paid under cell phone excise tax for residential cell phones. Kentucky currently has this "tax on tax" for commercial cell phones and is required to equalize treatment.	+$0.5 million
Cumulative	**Depends on implementation**

A sales tax that best minimizes economic distortions is one that taxes all final retail sales once and only once. Kentucky, like most states, departs from this ideal by not taxing services while taxing business inputs, meaning some goods have no tax on them while others have multiple sales taxes. The Commission notes that they rejected a proposal to move toward a more sensible tax base, and most of the recommendations that they did adopt would make it worse. These include exempting the politically powerful Kentucky horseracing and direct mail industries, expanding the hotel tax to online travel services, and taxing the tax paid on cell phones.

The "principles" the Commission adopted for expanding the sales tax to services are designed to preclude any actual expansion. While retailers must collect sales tax on nearly all sales of goods, lawyers, accountants, real estate agents, and other service providers collect nothing. This disparity would continue under the current proposal, and indeed, the list of "luxury" services where a tax increase would not reduce sales is quite a limited list. The report does not even recommend a final list for the legislature, instead reproducing two lists submitted as testimony. The report's analysis of the implications of taxing services is insufficiently thought out. Indeed, the Commission only includes two sentences in this section: "Positively impacted would be advocates for increased state revenues. Negatively impacted would [be] consumers of the newly-taxed services."[3]

Excise Taxes

Table 5: Excise Tax Recommendations

Change	Revenue Impact
Increase cigarette tax from 60 cents per pack to $1.00 per pack and impose a one-time inventory tax to discourage hoarding before the tax increase; raise smokeless tobacco tax proportionally	+$132 million
Repeal distilled spirits case tax	-$0.1 million
New excise tax on cigarette rolling papers	+$1 million
Adopt new 1 percent utilities gross receipts tax.	+$101 million
Clarify whether renewable energy utilities are subject to utility tax.	Depends
Set the minimum gasoline tax price floor at $2.616 per gallon.	None
Reduce dealers' compensation for collecting gasoline tax from 2.25 percent to 1 percent.	+$17 million
Repeal the Rural Electric Cooperative Corporation & Rural Telephone Cooperative Corporation Tax (collected $310 in FY 2011)	Minimal
Cumulative	**+$251 million**

Cigarette taxes may be justifiable as compensating society for the social costs of smoking (providing health care, for example),[4] but the Commission's report is up front that their proposal is strictly for revenue purposes, and the $1 per pack figure is derived by estimating what the tax rate could be without driving all purchases across the border with no discussion of social costs or negative effects.[5] This is not tax policy based on sound principles.

[3] *Report*, *supra* note 1, at 35.

[4] However, economists disagree on the proper tax rate. *See* W. Kip Viscusi, *Cigarette Taxation and the Social Consequences of Smoking*, National Bureau of Economic Research Working Paper No. 4891 (1994), http://www.nber.org/papers/w4891.pdf.

[5] *Id.* at 39-40.

Property Tax

Table 6: Property Tax Recommendations

Change	Revenue Impact
Repeal inventory tax.	-$4 million
Freeze state property tax at 12 cents per $100 of value.	-$8 million initially, positive later
Impose property tax on watercraft and aircraft using rental space.	Unknown
Remove select categories from the tangible personal property tax (agricultural inventories, non-commercial aircraft and watercraft, foreign trade zone property, Beds energy facilities, manufacturer and agricultural machinery held for sale).	-$5 million
Tax pollution control equipment under personal property tax.	+$1 million
Tax wireless equipment under personal property tax.	+$5 million
Require that inventory-in-transit (excluded from the personal property tax) be delivered out-of-state within 6 months.	Unknown
Review current disparity between taxing federally documented boats (1.5 cents per $100 of value) and state-registered boats (45 cents per $100 of value).	Depends
Cumulative	**-$11 million**

States are moving away from taxes on tangible personal property, as they are complex, costly for businesses to comply with, and discourage business investment.[6] The Kentucky commission rejected full repeal of the state personal property tax, instead adopting recommendations to eliminate it for some categories and expand it to others. However, they recommend repealing the inventory tax, which is another harmful tax for business investment.

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[6] Joyce Errecart, Ed Gerrish, & Scott Drenkard, *States Moving Away From Taxes on Tangible Personal Property*, TAX FOUNDATION BACKGROUND PAPER NO. 63 (Oct. 4, 2012), http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property.

Other Recommendations

Table 7: Other Recommendations

Change	Revenue Impact
Expand severance tax to limestone exports.	+$2 million
Decouple from federal definition of coal "gross value," thus applying the severance tax to coal processing as well as mining.	+$6 million
Tax advance deposit horse race wagers.	+$6 million
Review all tax incentives every 5 years.	None
Allow trade-in deduction for new car purchases for the car tax.	-$34 million
Allow local sales taxes.	Depends
Permit local governments to raise property tax revenues by more than 4 percent per year.	Depends
Refuse to issue drivers' licenses to delinquent taxpayers.	+$3 million
Allow greater administrative power to collect tobacco tax from cigarette making machines and shops.	+$3 million
Equalize statute of limitations for both assessment and refund claims; allow 60-90 days to protest an assessment.	Unknown
Allow businesses to file income tax withholding form electronically rather than by paper.	None
Provide additional time (up to 180 days) for multijurisdictional taxpayers to report changes on their federal return.	None
Allow the Department of Revenue more flexibility in arranging installment payments.	Minimal
Pay the same interest rate on refunds as is collected on assessments.	-$8 million

Proposals Rejected By the Commission

Table 8: Rejected Proposals

Individual Income Tax

- Higher individual income tax rates.
- Set the individual income tax base as federal AGI minus a significant standard deduction and the EITC.
- Remove the spousal division on income and deductions.
- Create a homeschooling tax credit.
- Exempt all filers not required to file a federal income tax return.

Corporate Income Tax

- Allow sale of tax credits between companies.
- Create a tax credit for supporting public or private schools.
- Eliminate capital gains tax for Kentucky-headquartered startups.
- Repeal the limited liability tax or the corporate income tax.
- Repeal the limited liability tax on unprofitable businesses.
- Require combined reporting for corporations.
- Review coal industry tax incentives.
- Tax all corporate income earned anywhere in the United States.

Sales Tax

- Exempt business-to-business transactions, including business purchases of utility services.
- Exempt half or all of the cost of a manufactured home.
- Tax the auction price of thoroughbred horses.
- Exempt livestock antibiotics.
- Implement a sales tax holiday.
- Tax food for consumption at home.
- Raise the rate.
- Allow all forms of local government to adopt a meals tax.
- Replace local meals taxes with a statewide meals tax.

Excise Taxes

- Tax residential utilities.
- Adjust the gasoline tax for inflation.

Property Tax

- Allow school districts to maintain the property tax rate even when collections exceed the 4 percent increase cap.
- Eliminate the tangible personal property tax.
- Exempt development companies.
- Exempt aviation.
- Replace the homestead exemption for those over age 65 with a means-tested circuit breaker.

Other

- Raise the coal severance tax.
- Eliminate Tax Increment Financing (TIF) districts.
- Implement an estate tax.
- Eliminate the estate tax.
- Sunset tax incentives.
- Expand the hospital tax to doctors.
- Eliminate local occupation taxes for low-population counties.
- Create a uniform state occupational tax form.
- Eliminate “pay to play” requirement for challenging state taxes.
- Make corporate officers personally liable for motor vehicle usage tax.

Conclusion

Governor Beshear has set out excellent principles for reforming the state's tax system in a fair way that would meet the state's future competitive and revenue needs. Only some of the Commission's concrete proposals advance this vision. Some, such as the tax on online travel services, or the half-baked effort to expand the sales tax to services, or the new tax incentives for horseracing, suggest that other motivations overrode the interests of good state tax policy.

The report opens by referencing our *State Business Tax Climate Index* finding that Kentucky has the 19th best tax system in the nation. To be the place where future investment and job creation goes, Kentucky will have to do better.

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