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From 96 Options to 54 Recommendations
Tax Reform Commission Submits Report to Governor

Erica L. Horn

The Blue Ribbon Commission on Tax Reform ("Commission") concluded its work and submitted its recommendations to Kentucky Governor Steve Beshear on Monday, December 17, 2012. Following six public hearings, presentations by the Department of Revenue and Office of the Budget Director, and four work sessions, the Commission narrowed and refined a total of 96 options for reform to 54. The 54 recommendations are estimated to raise approximately $659 million in tax revenues for the state's General Fund.

The recommendations are divided into categories ranging from individual income tax changes to reforms aimed at simplifying compliance with and administration of Kentucky's tax statutes. A review of significant recommendations follows.

Individual Income Tax

The most important individual income tax reforms include a slight lowering of the individual income tax rates, including lowering the top rate from 6.0% to 5.8%; a refundable, earned income tax credit equal to 15% of the federal credit; limiting itemized deductions to $17,500; taxing pension income in excess of $30,000; and updating of the existing reference to the Internal Revenue Code from December 31, 2006 to December 31, 2012. These amendments are estimated to raise approximately $475 million in revenue.

Corporation Income Tax

Major changes to the corporation income tax also are recommended. Those changes include amending the current double-weighted sales, three-factor apportionment formula to a single, sales factor apportionment formula; adopting destination sourcing for services; changing the $3 million threshold for payment of the limited liability entity tax to $1 million; establishing an angel investor tax credit program; expanding the state's research and development tax credit to cover "human capital"; fully decoupling from the federal deduction for domestic production activities; and lowering the top corporation tax rate from 6.0% to 5.8%. The fiscal impact of these changes is estimated to be a negative $104 million.

Sales and Excise Taxes

The sales tax proposals include, but are not limited to, broadening the sales tax to certain services; imposing a gross receipts tax of one percent (1%) on both residential and business utilities; increasing the tax rate on cigarettes from $0.60/pack to $1.00/pack; exempting hay, feed and other agricultural supplies used by the equine industry; and imposing sales tax on prewritten computer software accessed from the cloud. The Commission recommends the following "principles" be followed in identifying the specific services subject to tax: household-consumption based; luxury items; services tied to products already taxes; services that have inelastic demand; sensitivity to border states' sales taxes; and services that have a clear nexus to Kentucky. The amendments to the sales tax statutes are estimated to increase revenue by approximately $306 million.

Property, Severance and Other Taxes

Other recommended changes include: create an income tax credit for the bourbon industry to offset the property tax on stored barrels of bourbon that is imposed by local taxing districts; exempt inventory (merchant's inventory, manufacturer's finished good and goods stored in warehouses) from ***state*** property taxation; freeze the state property tax rate at 12 cents per $100 of value; eliminate the export credit from severance tax for certain limestone shipments; amend the definition of "gross value" to ensure that processors of minerals understand they are liable for the severance tax; and impose the pari-mutuel tax on advance deposit wagers made on live races conducted at Kentucky race tracks. The fiscal impact of some these changes are unclear. For those on which a value could be placed, it is estimated that the amendments would have a negative fiscal impact of $24 million. Approximately one half of this impact is the result of the credit for the bourbon industry, which is estimated to result in a loss of revenue of $12.6 million.

Simplicity, Compliance and Tax Administration

There are a series of recommendations related to tax compliance and administration. Many would be of benefit to taxpayers; for example, apply the statute of limitations evenly to assessments and refund claims; extend the number of days to protest an assessment from 45 to at least 60 and preferably 90 days; give multijurisdictional taxpayers a minimum of 180 days to report changes on a prior federal return; and return to a balanced interest rate on assessments and refunds. The fiscal impact of applying the statute of limitations evenly is described as a "potential large decrease in revenues". The return to a balanced interest rate on assessments and refunds is noted to have a negative impact of $8 million.

Three recommendations in this area have a projected positive impact on Kentucky's General Fund. First, the Commission recommends that the Department of Revenue be allowed to prohibit renewal of professional licenses, drivers' licenses and vehicle registrations if taxpayers refuse to pay state taxes after all appeals have been exhausted. This proposal is expected to raise almost $6 million. Second, clarifying the existing tobacco laws will enable better enforcement by the Department, which should increase revenue by approximately $3 million. Finally, imposition of use tax notification and compliance requirements on remote vendors is estimated to generate $5 million.

Road Fund and Local Taxes

While not within their explicit charge, the Commission does make three recommendations related to the Road Fund and two related to local taxes. With regard to the Road Fund, the Commission's recommendations include: stabilize fuel tax revenues by raising the floor of the average wholesale price; reduce dealer's compensation for motor fuels tax reporting from 2.25% to 1.0%; and implement a trade-in credit for new vehicle purchases so that used and new vehicles are treated the same. The net impact of these recommendations is a decrease in the Road Fund of $13 million. This loss primarily would be from the impact of the trade-in credit on new vehicles, which has an estimated fiscal impact of a negative $34 million.

The Commission has two recommendations related to local taxes. The first is to amend the Kentucky Constitution to permit "local option sales taxes". The testimony regarding this recommendation has been confusing as some people have testified in favor of a general sales tax available to all localities while others have talked about a sales tax levied for accomplishing a specific purpose. The clearing of the confusion will only come with the language of any actual amendment. Also, the Commission recommends that school boards be permitted to increase property tax revenues in excess of the current 4.0% annual limit ***without*** the risk of a voter recall.

Conclusion

The total General Fund impact of the recommendations of the Commission approximate $659 million. A link to the full report is below. The report provides a description of each recommendation, a list of options rejected, and papers submitted by individual taxpayers, business coalitions and others.

http://ltgovernor.ky.gov/taxreform/Documents/Report/TaxReformCommissionReportFinal.pdf.

There are signs of a tough road ahead for the recommendations. On Sunday, December 16, 2012, the Louisville Courier-Journal published an article titled, "Tax reform ideas draw Kentucky lawmakers' ire". Some legislators opined it might be easier to increase the sales tax by a penny than to implement the Commission's recommendations. If this comes to pass, this Commission would become yet another in a long line of ignored tasks forces, commissions and advisory groups in Kentucky.