REPORT BY THE

Blue Ribbon Commission on Tax Reform

TO

GOVERNOR STEVE BESHEAR

December 17, 2012

Dear Governor Beshear:

In February 2012, you established the Governor's Blue Ribbon Commission on Tax Reform. This Commission was charged with conducting an extensive review of Kentucky's tax code, and, as Chairman, it was my responsibility to lead the Commission in the development of recommendations that modify our tax code to make it more responsive to the ups and downs of the economy, as well as to ensure that taxes are more equitable for Kentuckians.

With the assistance of state government experts and outside consultants, as well as input from Kentucky citizens, the Commission conducted a thorough review of how to better align our tax code with the principles of a 21st Century economy. As specified in the executive order, these principles are fairness, competitiveness, adequacy, elasticity, simplicity and compliance. Together, the Commission believes that an improved tax code will not only create a more welcoming business environment, but will also allow the state to invest in the services and priorities that best position our citizens for success. That is what our work was all about.

As a part of this effort, the Commission conducted a total of 15 public meetings, including one in each of Kentucky's six Congressional Districts. All state taxes were on the table for discussion during this process. All proposed ideas to the Commission were presented at either public hearings, submitted through our commission website, or sent to us through mail. This endeavor required the Commission to review numerous materials and proposals filled with technical data, research and analysis that addressed very complex tax policy issues at the local, state and national level. The Commission, with the support of our consultants, staff and outside experts, assessed all proposals to ensure alignment with the five principles that you outlined to create a balanced tax system for the Commonwealth.

Based on this intense and in-depth work and analysis, attached you will find a report from the Commission that outlines our recommendations and chronicles the work that led us to these recommendations.

I am very proud of the work achieved by this Commission in such a short period of time. I am mindful that this is a first step in what will, without doubt, be a continued journey toward the important goal of improving Kentucky's tax code.

Respectfully,

Lieutenant Governor Jerry Abramson

Members of the Blue Ribbon Commission on Tax Reform

Roszalyn M. Akins, dean of students at Leestown Middle School, director of family life ministries and of the women's ministry at First Baptist Church of Bracktown, founder of Future BMW (Black Males Working).

Jason M. Bailey, director of the Kentucky Center for Economic Policy (KCEP), research and policy director of the Mountain Association for Community Economic Development.

James H. Booth, founder of Booth Energy, board member of the University of Pikeville, Morehead State University, Inez Deposit Bank, Honey Branch Economic Development Authority, Coal Operators Associates, and the Kentucky Chamber of Commerce Executive Committee.

Ulysses L. Bridgeman, Jr., CEO of Bridgeman Foods Inc., owner and president of Manna Inc. and oversees the administration and operation of 160 Wendy's restaurants in five states and 103 Chili's restaurants in seven states. Board member of Fifth Third Bank.

Rocky Comito, former president of United Auto Workers Local 862 in Louisville, Kentucky.

Luther Deaton, Jr., chairman, president and CEO of Central Bank and Trust Co. and Central Bancshares Inc., of Lexington, member of the American Bankers Association Government Relations Council, past president of the Kentucky Bankers Association and past chairman of the Kentucky Chamber of Commerce and Commerce Lexington Inc.

Marion C. Forcht, controlling co-owner of Forcht Group of Kentucky, Forcht Bank, N.A., and president of Forcht Insurance Agency Inc., board member of Kentucky National Insurance Co., Kentucky Mutual Insurance Co., Kentucky Home Life Insurance Co. and Forcht Broadcasting Inc., corporate secretary of Kentucky Mutual Insurance and Kentucky Home Life Insurance companies.

R. Richard Rick Jordan, Jr., former vice president of Maytag Corp., former president of American Sign & Marketing, former vice president and general manager over LSI Graphic Solutions Plus, founding chair of the Gateway Community & Technical College board of directors, past board member of the Northern Kentucky Chamber of Commerce.

Pat Mulloy, chairman and CEO of Elmcroft Senior Living, former president and CEO of Louisville-based Atria Inc., former secretary of the Kentucky Finance and Administration Cabinet, chairman of the board of trustees for Bellarmine University and chairman of the Board of Advisors at Vanderbilt School of Law.

Shelia A. Schuster, Ph.D., executive director of the Advocacy Action Network, an umbrella organization that includes the Kentucky Mental Health Coalition, Kentuckians for Health Care Reform, the United 874K Disabilities Coalition and the Kentucky Medicaid Consortium.

Stu Silberman, executive director of the Prichard Committee for Academic Excellence, former superintendent of Fayette County Public Schools and Daviess County Schools.

Lee T. Todd, Jr., former University of Kentucky president and a professor of engineering, founder of two high-technology companies based on his university research, Projectron Inc. and DataBeam Corp.

Leslie A. Weigel, former banking executive at SunTrust Banks and former consultant to Head Start programs throughout the southeastern United States, current vice chair of the Service One Credit Union Board in Bowling Green.

John A. Williams, Sr., founder and chairman of Computer Services Inc. (CSI), former chairman of the Federal Reserve Bank of St. Louis, Louisville Branch; a founder and former president of the Association of Financial Technology.

Joe Wright, former majority floor leader of the Senate and chairman of the Senate Agriculture and Small Business Committee, former chairman of the Breckinridge County School Board and president of the Burley Tobacco Growers Cooperative, full-time farmer and co-owner of Wright Implement Co.

Cathy S. Zion, president and publisher of Zion LLC, which manages Today's Woman magazine, Today's Transitions magazine and Today's Family magazine, former vice president of operations at Fifth Third Bank of Kentucky, board member of BB&T Louisville and Regional Advisory Board of Directors and Louisville SCORE Advisory Board, chair of Kentucky's Commission on Small Business Advocacy.

Non-voting ex-officio members:

Senator Bob Leeper, Chairman, Senate Appropriations and Revenue Committee
Senator Paul Hornback
Senator Gerald Neal

Representative Rick Rand, Chairman, House Appropriations and Revenue Committee
Representative Jim Wayne
Representative Bill Farmer

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Executive Summary

CURRENT STATE OF KENTUCKY'S TAX CODE

In 2011, the national Tax Foundation ranked Kentucky 19th best in the nation both in its business tax climate and in the growth rate of new jobs over the past year. Another recent report by the U.S. Chamber of Commerce ranked Kentucky eighth in the nation for taxes and regulations, and 12th for job growth over the past two years.

Services provided to Kentucky's citizens by the state and the tax structure used to finance those services reflects the values and priorities of Kentuckians. The tax system is a particularly important aspect in the structure of government because it transfers incomes and resources from individuals and businesses into public services and support systems for those businesses. Over the years, there has been significant debate and review of Kentucky's tax code.

According to the Long Term Policy Research Center, Kentucky is "competitive" when compared to neighboring states. However, a number of economic, demographic, and political trends suggest that Kentucky's state and local revenue generation might not be adequate to support the needs of Kentucky's citizens and businesses. In order to ensure that adequate revenue growth is achieved, past studies indicate that the state must carefully craft modifications to our existing tax code that will enhance the stability and growth potential of our state revenues without creating unintended consequences or disincentives to raise families and operate businesses within our borders. In addition, these modifications must be as simple and transparent as possible, thus minimizing any economic distortions which could adversely impact tax collections and compliance. Finally, the tax system should achieve a natural and efficient use of income, consumption, and property taxes in the overall state and the local tax system. Kentucky currently has a $3,059 state and local tax burden per capita. As a share of state personal income, the state and local tax burden rate equals approximately 9.3 percent of total income.

Kentucky has undergone 12 tax reform studies since 1982. These include the November 1982 Revenue Cabinet Study "A Proposal to Reform and Simplify the Kentucky Tax System" and the November 1995 "Blueprint for Comprehensive Reform" from the Kentucky Commission on Tax Policy, to the February 2002 "Report to the Sub-Committee on Tax Policy Issues by William F. Fox and Governor Ernie Fletcher's "Jobs and Opportunity Bipartisan Solution for Kentucky in January 2005.

However, concerns remain. "A quiet crisis is building when it comes to Kentucky's future and the General Assembly must no longer ignore a host of experts who have been warning for more than a decade that the state's tax structure is fundamentally unsound," said a September 2012 Courier Journal editorial. "Kentucky isn't bringing in enough money to pay the bills and the problem is getting worse."

GOVERNOR BESHEAR'S BLUE RIBBON COMMISSION ON TAX REFORM

Governor Beshear believes that in order to address concerns, Kentucky's tax system should be more administratively efficient and less burdensome. These laudable objectives are vital to the

success of any tax reform proposal. Business entities and households deserve a less-burdensome taxing system. The Commonwealth recently concluded a Tax Amnesty initiative where the opportunity was given to taxpayers to correct any outstanding tax obligations. Simplicity and ease of compliance were prominent in the foreground of this program. A second major objective was to collect all taxes that were due and owing such that the Commission could directly observe that the fiscal problem was not simply due to poor rates of collection. While results are still being tabulated, the Department of Revenue feels as if the Amnesty program was successful. However, it also demonstrated that even in periods of enhanced revenue collection, substantial changes must be considered to Kentucky's tax code in order to create a sustained and dynamic revenue stream.

On February 9, 2012 Governor Steve Beshear signed Executive Order #2012-103 establishing the Blue Ribbon Commission on Tax Reform. (See Appendix for list and biographies of Commission members.)

Twenty-three Kentuckians, representing a broad spectrum of public and private sector experience and all corners of the state, were appointed to serve on the Commission. Legislators selected by leadership from both the House and the Senate also served as ex officio non-voting members. Staff, consultants and other outside experts were named to assist in the review process. In particular, the Kentucky Society of Certified Public Accountants and the Kentucky Bar Association served as advisors.

THE COMMISSION'S CHARGE

Governor Beshear's Blue Ribbon Commission on Tax Reform was tasked with developing a set of recommendations to make the state's tax code more responsive to changes in the economy, as well as to make taxes more equitable for Kentuckians. Specifically, the Governor urged the Commission to consider five principles: fairness, competitiveness, simplicity and compliance, elasticity and adequacy.

The Commission, with the assistance of staff, consultants and advisers from both inside and outside of state government, conducted a comprehensive study of the Commonwealth's tax structure and recommends changes to the tax code in order to meet the long term needs of the state's economy and its citizens. As mandated by executive order, the Commission performed the following tasks:

- Studied the burden of taxation on Kentucky taxpayers, both individuals and businesses, as compared to taxpayers in other states.
- Reviewed recent changes and proposed modifications in the tax structures in other selected states.
- Thoroughly examined and addressed tax policy considerations concerning the issues of adequacy, efficiency, fairness and equity, as well as economic competitiveness to determine whether the state's tax code currently operates in furtherance of these stated objectives.
- Held public meetings to receive input from the general public and interested parties and received testimony from experts in public finance, taxation and other stakeholders. Six of the fourteen public meetings were conducted in each Congressional District. Meetings

took place in Paducah, Bowling Green, Louisville, Covington, and Prestonsburg and Lexington.

As requested by the Governor, the Commission focused on the following principles.

Fairness
Charge from the Governor: The tax system should treat people equitably. The Commission will review the tax burden that different taxpayers shoulder, from Kentucky families to Kentucky businesses, from small businesses to big businesses, and within different industry sectors in the state.

Competitiveness
Charge from the Governor: Any changes to the tax system should ensure that Kentucky continues to attract jobs and investment to the state, while keeping and protecting the jobs and businesses we already have. The Commission will review how Kentucky's tax environment compares to other states, in particular our competitor states, and identify ways to improve business tax competitiveness.

Simplicity and Compliance
Charge from the Governor: A tax system should be easy to understand and follow. The Commission will make recommendations to ensure compliance with Kentucky's tax system is simple for individuals and businesses and to ensure efficient administration by the state.

Elasticity
Charge from the Governor: The tax code should allow state revenue performance to mirror economic performance. While Kentucky's code has performed relatively well during the recession, revenue growth has not kept pace with changes in the economy.

According to the report from the consultants to the Commission, "Kentucky's recurring budgetary problems are due, in part, to the long-term decline in revenue elasticity – a measure of whether revenue is keeping pace with the economy. There are several economic, demographic and political factors contributing to the gradual reduction in elasticity. A multitude of systemic factors affect these sources of revenue, including the gradual shift in personal income away from taxable sources (e.g., wages, salaries, and proprietors' income) and toward mostly nontaxable sources (e.g., some transfer payments and nontaxable employee benefits); the transition from a goods-producing economy that is taxed to a service-providing economy that is largely untaxed; the rise of "mail order" or remote sales, which includes Internet and catalog purchases; an aging population

"I have the privilege to attend a brand new school at Southborn High School. But as I look at all the new technology and opportunities the facility provides to me and my fellow classmates, I can't help but think of the students who do not get to share these opportunities. This to me is wrong because I believe students in Kentucky should have an equal opportunity to use technology in the classroom, learn from teachers, and afford college or tech school to ensure a future job."

—JACOB ABRAHMSON, BOWLING GREEN

whose spending patterns generate less revenue compared to younger cohorts; and the prevalence of tax exemptions. Given the systemic nature of these changes, the long-term decline in revenue elasticity will likely continue in the absence of tax reform."

Adequacy
Charge from the Governor: The Commonwealth's tax structure should generate sufficient funds to support critical state services. The Commission is charged with reviewing the adequacy of revenues from the current tax structure and making recommendations for improvement.

PRESENTATIONS TO THE COMMISSION

Through its meetings, as well as through the Commission's website and the mail, the Commission received a prolific panorama of reform ideas from various stakeholders. Several of these proposals were introduced during one of the six regional meetings that were convened across the Commonwealth in order to gain input from citizens in each congressional district.

The Commission began with three meetings in the State Capitol to gain a general understanding of the current tax code, the past history of tax reform efforts, and any current concerns regarding the current code.

Greg Harkenrider of the Governor's Office for Economic Analysis led the Commission through presentations of "Taxation Boot Camp," "Prior Tax Reform Initiatives" and "Tax Reform Options." (See Appendix for each presentation.) "Tax bases should be defined as broadly as possible to reduce horizontal and vertical inequities caused by excluding economic activity from the base. Uniform tax rates should be applied to all sources of income, categories of consumption, or types of property that are included in the tax bases."

Lt. Governor Jerry Abramson invited experts from all of Kentucky's university schools of business to make presentations; Paul Coomes, Professor of Economics at the University of Louisville College of Business presented "Economic Geography Issues and implications for fiscal policies in Kentucky," and Robert L. Salyer, Instructor of Accountancy and Director of the Master of Accountancy Program at Northern Kentucky University presented "Gross Receipts Taxes: An Overview."

Armed with the information on current taxes, the Commission hit the road to receive input on proposed changes. Holding an evening meeting in each of Kentucky's congressional districts, the Commission heard from hundreds of Kentuckians, staying at each meeting until each and every citizen who wanted to speak had been heard. In Paducah, the Commission heard from 16 presenters, while in Lexington the Commission heard from 48 presenters. (See the Appendix for a list of presenters.)

In addition, the Commission created a website to take information, thoughts, concerns and proposals from individuals and groups unable to attend the Commission meetings. These submissions ranged from comments from AARP to proposals from the Kentucky Chamber of Commerce. (See the Appendix for a list of submitters.)

These presentations, from groups large and small as well as ordinary citizens, provided a wealth of information and context to the Commission, as well as numerous specific proposals for reform to the tax code.

Following the town hall meetings in Congressional districts, the Commission returned to Frankfort and received the final report by the consultants hired to assist the Commission – Dr. William Hoyt, Dr. William Fox, Michael Childress, and James Saunoris (See below). They also received presentations from the Kentucky Society of CPAs, the Kentucky Department of Revenue and the Office of the State Budget Director. (See the Appendix for these presentations.)

According to Lori Flanery, the Secretary of Kentucky's Finance and Administration Cabinet, the Department of Revenue administers more than 70 taxes and fees, as well as 625 forms and related schedules and a significant number of exemptions. She said that tax reform is needed to reduce complexity of the current tax code; reduce the cost of compliance for taxpayers; reduce the Department's cost of administration; and increase voluntary compliance.

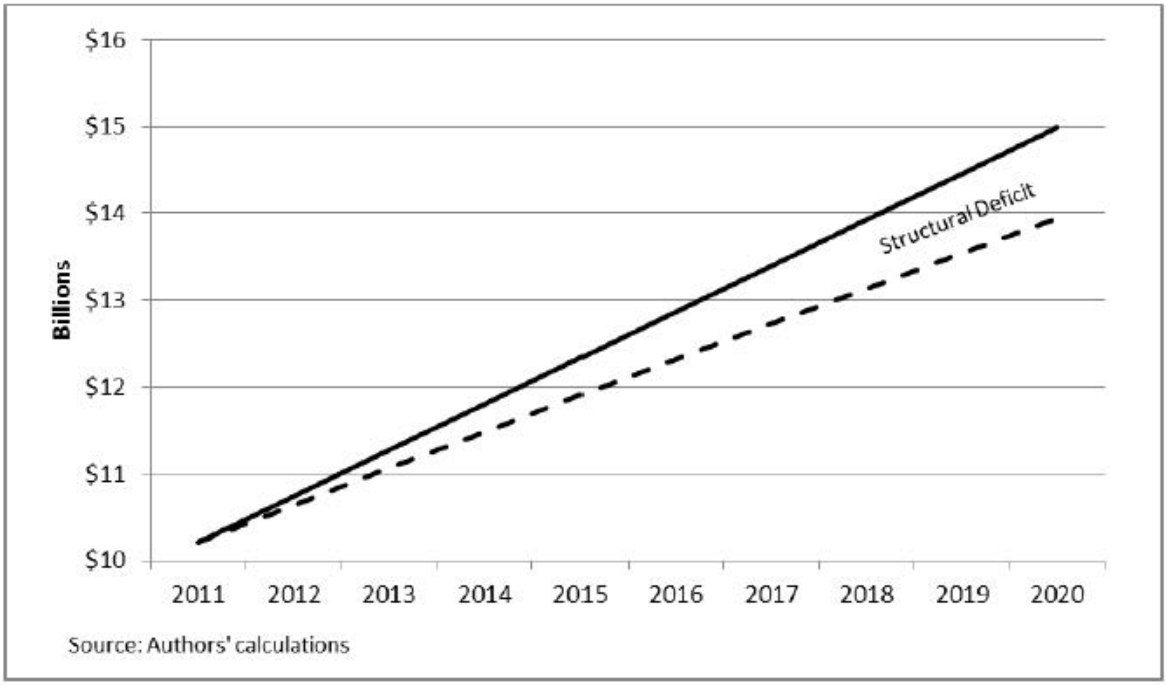
Finally, on October 23, the Commission received a profile created by the Department of Revenue and Greg Harkenrider that provided an analysis of each tax reform proposal to the Commission, along with background information, how other states treat that issue, what groups would be negatively or positively impacted by the proposal, a revenue impact and a score on the Commission's five principles.

REPORT BY THE CONSULTANTS TO THE COMMISSION

The Commission selected a team of Dr. William Hoyt and Michael Childress of the University of Kentucky and Dr. William Fox of the University of Tennessee to assist in their work and make recommendations. Dr. Hoyt is the director of the Martin School of Public Policy and Administration at UK, and Childress is with the Center for Business and Economic Research at UK's Gatton College of Business and Economics. Dr. Fox is a professor in the department of economics at the University of Tennessee and the director of the university's Center for Business and Economic Research. He has served as a consultant on finance, taxation, and economic development in a number of states, including prior tax reform efforts in Kentucky, and in developing countries.

The consultants hired to assist the Commission in their work presented the following general findings:

- "Two basic points come from our analysis of Kentucky's tax system: a broader tax base is needed so that revenue can keep pace with future economic growth, and changes are needed to improve Kentucky's economic competitiveness.
- Without fundamental reforms Kentucky could face a $1 billion shortfall by 2020, and could find itself at a competitive disadvantage to neighboring states for business growth, retention, and recruitment.
- …These options are based on two core ideas – broadening the tax base will make the system more elastic, and shifting taxation away from business capital and labor earnings, and toward consumption, will make it more competitive."



According to the report from the consultants to the Commission, "**Kentucky faces a structural deficit that could reach $1 billion by 2010** *(emphasis added)*. Revenue growth in Kentucky has slowed in the last several years, especially when compared to earlier periods. From 2001 to 2011, tax revenue failed to keep pace with the economy or declined more than the economy in eight years while revenue growth exceeded economic growth in three years. If the revenue trend demonstrated from 2000 to 2008 continues to 2020, then state government would decrease to below 6.5 percent of the economy – a level not seen since 1968 when it was 5.9 percent. Revenue elasticity for total tax revenue for 2000 -2008 in Kentucky was 0.81 – a 10% increase in personal income only yields an 8.1% increase in tax revenue. For the individual income tax it was 0.82 and for the general sales tax it was 0.87…Addressing this structural deficit promises to become more difficult in the future since the underlying economic, demographic, and political trends reducing elasticity are continuing and show no signs of abating. Moreover, there are a number of financial factors likely to intensify state level budgetary pressures in the future, such as Kentucky's $30 billion unfunded pension obligation and long-term fiscal problems at the federal level."

The consultants presented the following 20 options to the Commission:

Individual Income Tax options:

- Conform the Kentucky Individual Code to the Federal Code as of a specific date.
- Enact a State Earned Income Tax Credit (EITC).
- Tax Pension and IRA income.
- Make Taxable Income equal to Federal Adjusted Gross Income (AGI) less a significant standard deduction and tax credit for low income households.

Sales Tax Options:

- Broaden sales taxes to selected services.
- Impose a state gross receipts tax of up to 3 percent on providers of electricity for residential use.
- Impose the sales tax on food for consumption at home and provide a tax credit or other means to offset the additional tax burden for low-income households.
- Exempt business purchases of energy.
- Impose a gross receipts tax of between 1 and 3 percent on both residential and business electricity.
- Support federal legislation allowing states to require remote firms to collect the sales tax.

Business Tax Options:

- Conform the corporate income tax base with Federal Code as of a specific date.
- Add back management fees in calculation of the corporate income tax base.
- Use Destination Sourcing for Services.
- Lower the $3.0 million LLET threshold to $1.0 million and phase out the effects through $2.0 million.
- Replace the double-weighted sales formula with single factor sale apportionment for the Corporate Income Tax.
- Replace the Corporate Income Tax and LLET with a Gross Receipts tax or with some other sources of revenue.

Property Tax Reforms

- Eliminate personal property taxation.
- Exempt inventory from property taxation and eliminate the Barrel Tax.
- Freeze the state property tax rate at 12 cents per $100 of value.

Local Tax Options:

- Permit a Local General Sales Tax.

(See Appendix for the full report.)

COMMISSION RECOMMENDATIONS

The Commission heard testimony and received information on a variety of topics and proposals. However, the Commission's charge was primarily focused on reform of the state's tax code. These proposals taken under consideration by the Commission were narrowed to 96 succinct proposals.

The 54 proposals that the Commission voted to approve are as follows:

Individual Income Tax

- Reduce the individual income tax rate structure as follows:

Adjusted Gross Income	Current Rate	Proposed Rate
$0-$3,000	2%	2%
$3,001-$4,000	3%	3%
$4,001-$5,000	4%	3.5%
$5,001-$8,000	5%	4.5%
$8,001-$75,000	5.8%	5.5%
$75,001 and over	6%	5.8%

- Enact an Earned Income Tax Credit (EITC) at 15 percent of the federal EITC.
- Limit itemized deductions to a $17,500 dollar cap that generates $350 million.
- Amend the pension income exclusion from $41,110 to $30,000, and phase out the exclusion for total income over $30,000.
- Change the reference to the Federal Code from December 31, 2006 to December 31, 2012.
- Implement a tax deduction for 529 savings plan contributions.

Corporate Income Taxes

- Lower the top corporate tax rate from 6.0 percent to 5.8 percent.
- Add back management fees in the calculation of the corporate income tax base.
- Change the current three-factor apportionment rule to implement single factor apportionment based solely on sales.
- Change the existing cost-of-performance based formula for apportioning sales to incorporate a destination sourcing for services.
- Amend the small-business standard from $3.0 million to $1.0 million and maintain the dollar-for-dollar phase-out for gross receipts or gross profits to $2.0 million.
- Establish an angel investor tax credit program for certain investments in small businesses.
- Expand the state's R&D Tax Credit to human capital; cap the amount available; and require that it is approved through some governing body, such as KEDFA.
- Fully decouple from the deduction for U.S. production activities (QPAI).

Sales and Excise Taxes

- Apply sales tax and transient room taxes to entire hotel accommodation price.
- Broaden the sales tax to selected services, with the following principles:
  - Household-consumption based,
  - Luxury items,
  - Services that have a clear nexus to Kentucky,
  - Tied to physical products already taxed,
  - Services that have an inelastic demand, such that the imposition of the tax would result in minimal household or business shifting to avoid the tax, and
  - Be sensitive to border state sales taxes.
- Exempt mail charges for direct mail from sales tax.

- Impose a gross receipts tax of 1 percent on both residential and business utilities and dedicate additional revenues to the SEEK funding formula.
- Increase collection of out-of-state and Internet sales. Support federal legislation allowing states to require remote firms to collect sales tax.
- Increase the tax rate on cigarettes to $1.00 and other tobacco products commensurate to the cigarette tax.
- Repeal the distilled spirits case sales tax.
- Restore Cigarette Rolling Papers Tax.
- Exempt the sales and use tax on certain equine products to support the signature equine industry.
- Apply sales tax to pre-written computer software made available for access without a download.

Property Taxes

- Create an income tax credit for the bourbon industry to offset the property tax on stored barrels of bourbon, without reducing local property taxes to school districts or local communities.
- Exempt inventory from state property tax (merchant's inventory, manufactured finished goods, and goods stored in warehouse).
- Freeze the state property tax rate at 12 cents per $100 of value.
- Clarify the identification of public service companies for taxation.
- Require reporting of the rental space for documented watercraft/private airplanes.
- Eliminate selected negligible state property tax rates for tangible personal property, with an emphasis on classes of property subject to the "State Rate" only.

Severance Taxes

- Eliminate the export credit under the minerals severance tax.
- Clarify the definition of "gross value" under severance tax.

Other Taxes/Issues

- Impose the Pari-mutuel tax on advance deposit wagers made on live races conducted at Kentucky race tracks.
- Provide for a review every five years of all tax incentives and expenditures.

Road Fund Issues

- Stabilize fuels tax revenues to support highway funding by raising the floor of the average wholesale price for fuels taxes.
- Reduce dealer's compensation on motor fuels tax from 2.25% to 1%.
- Implement a trade-in credit for new car purchases that would equalize the treatment for used vehicles and new vehicles.

Local Taxation Issues

- Amend Section 181 of the Kentucky Constitution to allow a local general sales tax.
- Remove the HB44 recall provisions for local and school real property taxes.

Simplicity, Compliance and Tax Administration

- Allow non-renewal of professional licenses, driver's licenses and vehicle registration if taxpayers have exhausted all appeals and still refuse to pay state taxes to improve collections.
- Amend tobacco tax laws to provide clarifications and administrative improvements enabling the Department of Revenue to better enforce Kentucky tobacco tax laws.
- Apply statute of limitations evenly to both assessments and refund claims. Extend the number of days to protest an assessment to at least 60 days, preferably 90 days.
- Clarify the definition of "pollution control facilities" under tangible personal property tax statutes.
- Define the terms "broadcast" and "telephonic equipment" in the tangible personal property tax statutes.
- Eliminate the need for paper Form K-1E, Kentucky Employer's Return of Income Tax Withheld.
- Give multijurisdictional taxpayers a minimum of 180 days to report changes on a prior federal return at the state and local level.
- Clarify installment payment agreement provisions.
- Repeal the Rural Electric Cooperative Corporation & Rural Telephone Cooperative Corporation Tax (one tax).
- Under the tangible personal property tax statutes, clarify that inventory-in-transit must be delivered to a permanent out-of-state destination in order to qualify for the under 6 month exclusion.
- Update use tax notification and compliance requirements for remote vendors.
- Return to a balanced interest rate on taxes owed to and by the state.
- Add clarifying language in KRS 139.480(11) regarding farm machinery that specifies combine header trailers are exempt from sales tax.
- Repeal the school tax rate exclusion from sales tax calculation on "residential telecommunications service" found in KRS 139.470(9).
- Review the disparity in the tax code and law between documented and undocumented boats.

INDIVIDUAL INCOME TAXES

Without question, the Commission devoted the most time and discussion to proposed changes to the individual income tax. With the large number of presenters who made proposals on the individual income tax, it is clearly a topic of high interest to the general public as well. In the end, the Commission took action on eleven proposals to significantly alter Kentucky's individual income tax system.

Background Information

The individual income tax is levied on taxable income, which is computed by reducing gross income by trade or business expenses and the standard deduction ($2,210 for 2010) or at the option of the taxpayer by itemized deduction. Gross income is defined as gross income under the 2006 Internal Revenue Code, with certain adjustments. Kentucky individual income taxes currently make up 31.3 percent of the distribution of state and local tax collections, compared with 21.3 percent of all states as a whole; individual income taxes make up 34 percent of the distribution of state tax collections, compared with 34.4 percent of all states as a whole.

When approaching Individual Income Taxes, State Chief Economist Greg Harkenrider made the following points:

- "The individual income tax is the primary tax type that introduces progressivity into a state tax system and thus affects the perception of fairness in the distribution of the tax burden.
- Horizontal equity (taxpayers with equal ability to pay should bear the same tax burden) and vertical equity (taxpayers with greater ability should have tax burdens at least equal to those with less ability to pay and necessary to achieve equity)."

According to the report by the consultants to the Commission, regarding state and local income taxes, "With the exception of the lowest income brackets, average tax rates (taxes/income) are from 1%-2% higher in Kentucky than for a weighted-average its competitor states."

The consultants noted the following concerns about Kentucky's current individual income tax:

- The individual income tax is complex with high compliance costs;
- Income tax burdens for low-income households are higher than in competitor states;
- The high marginal and average tax rates reduce competitiveness;
- Differential treatment of income and itemized deductions;
- Income taxation results in economic inefficiencies by distorting labor incentives and consumption choices; and
- Income tax revenue is not keeping pace with personal income.

The major options regarding reform of the individual income tax that were considered by the Commission were:

- Base broadening
    - Retirement income
        - Pensions (state, local, private, military, and federal)

        - 401K distributions
        - Individual retirement accounts
        - Federally taxable Social Security Income
    - Limiting of itemized deductions
        - Add-back of federal itemized deductions
        - Capping the nominal itemized deductions that transfer over to the state return
- Expanded low income relief
    - Higher exemptions
    - Refundable relief
    - Expanded credits
    - Based on a percentage of the value of the federal EITC
- Rate alterations
    - Bracket changes
    - Rate changes within existing brackets
    - Choosing between progressive and flat rate structures.

Commission Actions

PROPOSAL: Reduce the individual income tax rate structure as follows:

Adjusted Gross Income	Current Rate	Proposed Rate
$0-$3,000	2%	2%
$3,001-$4,000	3%	3%
$4,001-$5,000	4%	3.5%
$5,001-$8,000	5%	4.5%
$8,001-$75,000	5.8%	5.5%
$75,001 and over	6%	5.8%

Background information: The income tax was first levied in Kentucky on January 1, 1936. The tax rate was on a graduated scale from 2% to the highest 5% for all income in excess of $5,000. In 1950, the General Assembly increased the income tax rate to help finance poor school districts. The new top rate was 6% on income over $8,000. Rates did not change again until 2005 when the rate for income over $8,000 but less than $75,000 was lowered to 5.8%. Top rate over $75,000 remained at 6%, exactly where it stands today.

Due to the presence of local occupational license taxes in Kentucky, rates of income taxation in Kentucky are considered middle to slightly high. It should be noted that the state income tax is the primary mechanism whereby progressivity can be added to the overall tax structure that is somewhat regressive in the current form.

Other states: Since the onset of the last recession, at least 12 states have increased the top marginal income tax rate or enacted surcharges in order to increase the income tax. In 2009 alone, nine states altered their income tax policies in order to increase revenues. Eight of these increases entailed adding new tax brackets for high-income earners or increasing the top marginal income tax rate. North Carolina increased income taxes by adding a surcharge of 2%

and 3% on earners with more than $60,000 and $150,000 in income, respectively. 2010 was, in many ways, a repeat of 2009, but on a smaller scale. Oregon and Ohio enacted major increases in the income tax. Oregon created an 11% tax bracket for residents with incomes exceeding $250,000 and Ohio has postponed a planned reduction in their income tax rate for 1 year. Just recently, Illinois enacted current-year increases on income taxes while Minnesota has also proposed raising that top marginal rate and imposing a surcharge on high income earners.

For the 2012 tax year, the surrounding states rates are as follows: Illinois' tax rate is 5% of federal AGI with modifications, regardless of filing status; Indiana's tax rate is 3.4% of AGI, regardless of filing status; Missouri's tax rates are 1.5% to 6%, with income over $9,000 taxed at 6%; Ohio's tax rates are .587% through 5.925%, with income over 208,500 taxed at 5.925%; Virginia's tax rates are 2% to 5.75%, with income over $17,000 taxed at 5.75%; and West Virginia's tax rates are 3% to 6.5%, with income over $60,000 taxed at 6.5%.

Groups positively and negatively impacted: Those earning over $4,000 will see a rate reduction. Those programs relying on the General Fund would be negatively impacted.

Revenue Score: This rate structure would mean a loss of $219 million to the state.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	N

PROPOSAL: Enact an Earned Income Tax Credit (EITC) at 15 percent of the federal EITC.

Note: This resulted from a proposal from the Consultants to the Commission.

Background information: From the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants: "If the Commission wants to consider reducing the burden on lower income households, a State Earned Income Tax Credit (EITC) is one option. The EITC, unlike welfare and other means-tested transfer programs, should not adversely affect taxpayer behavior, in this case the incentives to work. While Kentucky could devise their own plan, we recommend that they follow the examples of Illinois and Indiana and "piggyback" on the federal EITC by offering a refundable credit that is a percentage of the federal EITC."

"Families are more likely to spend their EITC return on food, gas, and bills. An EITC also enables families to save money as well. Twenty-four other states have enacted an EITC and federal EITC has been one of the best examples of bi-partisanship to date."

—JORDAN WILDERMUTH, LEXINGTON

The federal EITC is a tax credit extended to low-wage workers. It was enacted in 1975 and made permanent law in 1978. The tax filer must be working and earning wages in order to qualify and the credit benefits families with children the most, and the value of the credit varies depending upon family size and income level.

Taxpayers may claim the full value of most tax credits only if their tax liability meets or exceeds the value of the credit. Stated another way, most tax credits cannot reduce a person's tax bill below zero. Three tax credits, the earned income tax credit (EITC), the child tax credit (CTC), and the small Health Coverage Tax Credit (HCTC), do not face that limitation; they are termed refundable because they can generate cash refunds that exceed the taxpayer's tax liability. Like the federal government, states have few refundable tax credits. However, 26 have an EITC, 22 of which are refundable and all but two at least partially refundable.

Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. Particularly in the cases of the EITC, precisely those low-income households most in need of assistance would be denied the benefit of the credits if they were not refundable. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

Opponents of refundable credits raise four objections: that the tax code should not redistribute income; that the government should not use the tax code to carry out social policies; that everyone should pay some tax as a responsibility of citizenship; and that refundable credits increase administrative and compliance costs and encourage fraud and abuse.

Pros:

- Adds progressivity (very few options in other taxes)
- Ability to tie to earned income
- Incentive to work by not penalizing wages earned
- Much more targeted than bracket changes
- Supporters would be advocates for low-income households

Cons:

- Unintended consequences (Not all filers with low Kentucky income are "poor")
- Does not help the middle class
- Redistribution arguably a federal tax responsibility

"I encourage the Commission and the Governor to look at the Earned Income Tax Credit. Right now, I earn a very low income and I pay 11% of my income in local sales and state tax—where the top 1% only pay 6%. This is not fair and this is not progressive tax reform."

—PATRICIA TARQUINO, BOWLING *Green*

Other states: Surrounding states' earned income tax credits

- Indiana – State EITC is 9% of federal EITC
- Illinois – State EITC is 5% of federal EITC, increasing to 10% over the next three tax years
- Virginia – State EITC is 20% of federal EITC, but is non-refundable

Groups positively and negatively impacted: Since this proposal would add progressivity to the tax code, this proposal would be beneficial to low-income workers. Negatively impacted would be groups relying on the General Fund.

Revenue Score: -$115.0 million, assuming a credit at 15 percent of the Federal Credit.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N or +	+	–	–	–

PROPOSAL: Limit itemized deductions to an approximate dollar cap of $17,500 that generates $350 million.

Background information: Under current law, there are a number of allowable itemized deductions:

- Medical expenses, to the extent that the expenses exceed 7.5% of the taxpayer's AGI. (e.g., a taxpayer with an AGI of $20,000 and medical expenses of $5,000 would be eligible to deduct $3,500 of their medical expenses (20,000 X .075 = 1,500; 5,000 - 1,500 = 3,500)) The 7.5% floor means that most taxpayers are unable to take advantage of the medical expense deduction. Allowable medical expenses include:
    - Capital expenditures that are advised by a physician, where the facility is used primarily by the patient alone and the expense is reasonable (e.g. a swimming pool for someone with degenerative spinal disorder, an elevator for someone with heart disease);
    - Payments to doctors, dentists, surgeons, chiropractors, psychologists, counselors, physical therapists, osteopaths, podiatrists, home health care nurses, cost of care for chronic cognitive impairment;
    - Premiums for medical insurance (but not if paid by another, or with pre-tax money);
    - Premiums for qualifying long-term-care insurance, depending on the taxpayer's age;
    - Payments for prescription drugs and insulin;
    - Payments for devices needed to treat or compensate for a medical condition (crutches, wheelchairs, prescription eyeglasses, hearing aids);
    - Mileage for travel to and from doctors and medical treatment; and
    - Necessary travel expenses.

  Non-deductible medical expenses include:
    - Over-the-counter medications;
    - Health club memberships (to improve general health & fitness); and
    - Elective cosmetic surgery.
- State and local taxes paid, including:
    - Local income taxes; and
    - Property taxes (assessed by reference to the value of the property).

      but not including:
    - Use taxes;
    - Excise taxes; and
    - Fines or penalties.

- Mortgage interest expense on debt incurred in connection with up to two homes, subject to limits (up to $1,000,000 in purchase debt, or $100,000 in home equity loans)
    - also, points paid to discount the interest rate on up to two homes; points paid upon acquisition are immediately deductible, but points paid on a refinance must be amortized (deducted in equal parts over the lifetime of the loan)
    - also private mortgage insurance premiums through 2012
- Investment interest, up to the amount of income reported from investments (the balance is deferred until more investment income is declared)
- Charitable contributions to allowable recipients; this deduction is limited to either 30% or 50% of AGI, depending on the characterization of the recipient. Donations can be made as money, or in the form of goods. The value of donated services cannot be deducted as a contribution. Reasonable expenses necessary to provide donated services can, however, be deducted (such as mileage, special uniforms, or meals). Non-cash donations valued at more than $500 require special substantiation on a separate form. Non-cash donations are deductible at the lesser of the donor's cost or the current fair market value, unless the non-cash donation has been held for greater than a year (Long term), in which case it can be deducted at fair market value.

  Eligible recipients for charitable contributions include:
    - Churches, synagogues, mosques, other houses of worship;
    - Federal, state, or local government entities; and
    - Fraternal or veterans' organizations

  Non-eligible recipients include:
    - Individuals; and
    - Political campaigns or political action committees (PACs).
- Casualty and theft losses, to the extent that they exceed 10% of the taxpayer's AGI (in aggregate), and $100 per event.
- Gambling losses, but only to the extent of gambling income (For example, a person who wins $1,000 in various gambling activities during the tax year and loses $800 in other gambling activities can deduct the $800 in losses, resulting in net gambling income of $200. By contrast, a person who wins $3,000 in various gambling activities during the year and loses $3,500 in other gambling activities in that year can deduct only $3,000 of the losses against the $3,000 in income, resulting in a break-even gambling activity for tax purposes for that year – with no deduction for the remaining $500 excess loss.)

This proposal would limit itemized deductions to $17,500.

Groups positively and negatively impacted: Since limiting itemized deductions would be an effective broadening of the base of taxation, positive impacts would be isolated to beneficiaries of the higher General Fund revenues. Negatively impacted entities would include charitable foundations, households that currently itemize deductions, Homebuilders and mortgage lenders would object due to the loss, or partial loss, of the home mortgage interest provisions.

Other states: Illinois – no standard deductions or itemized deductions; Indiana – no standard deduction, itemized deductions include a renters deduction and homeowners residential property tax; Missouri – standard deductions same as federal and itemized deductions same as federal with modifications to taxes paid; Ohio – no standard deduction or itemized deductions; Virginia

– standard deduction $3,000 single or married filing separately and $6,000 if married, and itemized deductions same as federal with modifications to taxes paid and gifts to charity; and West Virginia – no standard deduction or itemized deductions. Indiana, Missouri, and Ohio have deductions for social security benefits and interest on U. S. obligations.

Revenue Score: $350 million would be generated in tax revenue.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	–	+	+	+

PROPOSAL: Amend the pension income exclusion from $41,110 to $30,000, and phase out the exclusion for total income over $30,000.

Note: This is a proposal from the Consultants to the Commission, but modified by the Commission to lower the exclusion amount and to use Kentucky Taxable Income as the means-testing mechanism.

Background information: While policies vary widely, all state exclusions of some pension income have one of two purposes:

- Protecting the income of those no longer in the workforce
- Economic development – to attract or retain retirees

"It is representation without taxation."
—GORDON SYPHERT, LOUISVILLE

Kentucky currently has an exclusion of all "retirement-plan" income below $41,110, including income from IRAs, public pensions, private pensions, and various related plans. The proposal under consideration is to do a dollar-for-dollar reduction of the exclusion for total pension income over $30,000.

Revenue Score for the phase-out at $30,000, including all income: $485 million

Other states: Most states that levy a personal income tax allow people who receive retirement income to exclude part of it from their taxable income. Of the 41 states with a broad based income tax, 36 offer exclusions for pension income. Some states limit exclusion of pension income when significant non-pension income is reported.

According to a 2011 report from the National Conference of State Legislatures (NCSL), "States take two broad approaches to excluding retirement income from taxation. Some states provide a specific amount of exclusion according to the type of retirement income…Other states (and some of the same states) provide a retirement income exclusion that taxpayers

"If Kentucky would tax half or even a forth of the pensions collected in this state, it would ease our deficit and create a fair climate. Surely not one of our citizens think it fair that people who get pensions of $25,000 to $100,000 plus pay no state tax while those struggling to exist on a fraction of that amount as their total income must pay."
—SANDY JOINER, BOWLING GREEN

over a specified age, usually 62 or 65, can apply to non-earned income and in rare instances to some earned income…In addition to those in Colorado and Virginia, exclusions of this sort exist in Arkansas, Delaware, Georgia, Idaho, Iowa, Kentucky, Maine, Maryland, Minnesota, Missouri, Montana, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina, Utah and West Virginia. The amount of the exclusion varies from $2,000 in West Virginia to $41,110 in Kentucky."

Illinois: Pensions are fully exempted.
Indiana: Private and state pensions have no exemption.
Missouri: Taxes social security according to a schedule that is rising to 100 percent deductibility starting in 2012 as well as public pensions.
Ohio: A retirement income tax credit of up to $200 is allowed, depending on income.
Tennessee: State income tax only applies to interests and dividends.
Virginia: $12,000 pension exemption amount.
West Virginia: No exemption for private; full exemption for public safety state and local employees.

Groups positively and negatively impacted: Retirees would be negatively impacted. Generally, retired households have more freedom and resources to locate or relocate in states with favorable weather and limited income taxation. Taxation of retirement income could impede Kentucky's ability to retain and attract retirees. (However, one Commissioner notes a National Tax Journal article that says, "The results from all analyses overwhelmingly find no credible effect of state income tax breaks on elderly migration.") Retention of retired citizens would be marginally more difficult since retirement income (unlike earned income) can freely migrate to non-taxed jurisdictions. It would also be marginally more difficult to attract newly retired households. In a broader view, the choice of where to retire is a function of many factors: 1.) ties to family; 2.) ties to local friends and churches; 3.) a favorable tax code, and 4.) the entire tax code beyond the taxation of retirement income. Kentucky has low property tax rates, which would help retired households. Kentucky also has a narrow base of taxation with a relatively modest sales tax rate. Groups positively impacted would be anyone advocating for increased state revenue.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	+

PROPOSAL: Change the reference to the Federal Code from December 31, 2006 to December 31, 2012.

Note: This is a proposal from both the Consultants to the Commission and the Department of Revenue.

Background information: An Internal Revenue Code (IRC) reference date update from 12/31/06 to 12/31/12 is needed to simplify Kentucky's income tax forms and to improve voluntary compliance by taxpayers. As a general rule, optimal tax policy should include

segments of simplicity. Updating the Kentucky income tax reference date would certainly bring more uniformity, which should in turn lead to lower preparation cost for taxpayers and fewer instances of errors in calculations.

Other states: Kentucky's IRC reference date of 12/31/06 is the oldest used by any state, other than New Hampshire, which is 12/31/00. The reference dates for surrounding states are as follows: Illinois (IRC as currently amended); Indiana (IRC as of 01/01/11); Missouri (IRC as currently amended); Ohio (CAT – IRC as currently amended); Tennessee (Federal taxable income as currently defined by IRC); Virginia (IRC as of 12/31/11); and West Virginia (IRC in effect after 12/31/10 and prior to 01/01/12).

Groups positively and negatively impacted: Positively impacted would include CPA's, enrolled agents, tax software providers and taxpayers that would benefit greatly from the simplicity of fewer federal and state income tax differences. No group appears to be negatively impacted by a code update.

Revenue Score: Negative $25.6 million initially, but the fiscal impact turns positive after about four years.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	+	N	+

PROPOSAL: Implement a tax deduction for 529 savings plan contributions.

Background information: A 529 Plan is an education savings plan operated by a state or educational institution designed to help families set aside funds for future college costs. It is named after Section 529 of the Internal Revenue Code which created these types of savings plans in 1996. 529 Plans can be used to meet costs of qualified colleges nationwide. In most plans, your choice of school is not affected by the state your 529 savings plan is from. The Kentucky Education Savings Plan Trust (KESPT) is a college savings plan organized under Section 529 of the U.S Internal Revenue Code, and is administered by the Kentucky Higher Education Assistance Authority (KHEAA). Earnings from KESPT accounts are not subject to federal or state income taxes, if withdrawals are used for qualified higher education expenses. Additional federal tax benefits may accrue to account owners, since contributions may qualify for an annual federal gift tax exclusion.

Many states offer a state tax deduction for contributions made to an approved 529 plan in their state. For example, Illinois offers a deduction in taxable income for up to $10,000 per year for an individual and $20,000 per year for those filing jointly when residents contribute to an Illinois 529 plan. However, some states offer a state tax deduction for contributions by residents to any approved 529 plan, not just those sponsored by their state of residence. For example, Missouri offers up to $8,000 per year for an individual and $16,000 for those filing jointly when residents

contribute to any 529 plan. A Missouri resident utilizing a Virginia 529 plan would qualify for the tax deduction from taxable income.

Both approaches have been proposed in the Commonwealth in the past. House Bill 263 of the 2008 Regular Session proposed excluding $5,000 per year for individuals and $10,000 per year for those filing jointly. Based on historical contributions to the KESPT, the bill was estimated to have a fiscal impact of reducing state revenues by approximately $420,000 per year.

In 2009, House Bill 488 proposed allowing a credit against Kentucky income taxes of 20% (with a maximum of $1,000) of the amount contributed to any qualified 529 plan. This proposal was estimated to have a negative fiscal impact of approximately $14 million per year.

This proposal would limit the deduction to 529 plans sponsored by their state of residence, like House Bill 263.

Other states: From FinAid.org: "Many states give the account owner a full or partial state income tax deductions for their contributions to the state's section 529 plans. So far a total of 34 states and the District of Columbia offer such a deduction."

Groups positively and negatively impacted: Kentucky families saving for college would be the primary beneficiaries of any proposal to allow a tax deduction or credit for qualified contributions to a 529 college savings plan.

Revenue Score: -$420,000 per year

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	–	N	–

CORPORATE INCOME TAXES

With a heavy focus on the tax reform principle of competitiveness, the Commission looked closely at proposals that would enhance the Commonwealth's ability to attract and retain jobs for every community of the state. During the economic downturn of the past few years, the Commonwealth has been proactive in the effort to streamline its economic incentives toolbox. This achievement has been noted nationally, and has led to the creation of thousands of jobs. However, as the Commission noted, the state must continue to look for new and innovative ways to remain competitive, and numerous individuals and organizations made proposals to the Commission for consideration. States compete with each other in the attraction and retention of individuals and businesses. Tax policy should not be a deterrent to either goal. As stated by the Kentucky Association for Economic Development, "The Commonwealth's tax code is a primary factor considered by companies and site selection consultants in judging whether Kentucky is a favorable location for new business establishment or existing business expansion."

Background

From Greg Harkenrider: "Economic Efficiency"

- All taxes should have a minimal or neutral effect on the optimal behavior of individuals and businesses.
- An optimal tax system minimizes distortions to efficient behavior.
- All of the desirable properties of a free and open economy assume that economic agents (individuals and businesses) make their decisions on the economic merits of production functions and utility functions, not tax policy."

Corporate income taxes make up 3.6 percent of the distribution of state and local tax collections in Kentucky, compared to 3.6 percent for all states as a whole; they make up 4 percent of the distribution of state tax collections for Kentucky, compared with 5.5 percent for all states as a whole.

The tax base for the corporation income tax is taxable net income, which is essentially gross income minus allowable expenses and deductions, with apportionment and allocation provisions for multi-state corporations. The tax rate is four percent for the first $50,000; five percent for $50,000 to $100,000 and six percent for over $100,000. In Fiscal Year 2011, the corporate income tax generated $300.8 million.

According to the report from the consultants to the Commission, "Kentucky's top tax rate of 6% ranks as the third lowest rate among its competitors and is below the median of all corporate income taxing states. Five of Kentucky's competitors apportion using Double Weighted Sales and four use Sales only."

The consultants to the Commission said the following goals for corporate/business tax reform could include:

- Broaden the set of taxpayers;
- Seek to bring taxation of services more in line with the taxation of goods;
- Reduce the extent of estate planning; and

- Stimulate Kentucky's economy.

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Lower the top corporate tax rate from 6.0 percent to 5.8 percent.

Background information: One of the policy recommendations for the individual income tax was to lower the top marginal rate of taxation from the current level of 6.0 percent to 5.8 percent. The principle of horizontal equity urges parity in tax rates between the individual income and corporate income tax structures. Economic efficiency would be enhanced by this move because the rate of taxation should not unduly bias the decision of business formation. Rather, states should promote flexibility in that regard for reasons of competitiveness and simplicity.

Other States: The top corporate income tax rates for Kentucky's surrounding states are:

Illinois: 9.5%
Indiana: 8.5%
Missouri: 6.25%
Ohio: 0%
Tennessee: 6.5%
Virginia: 6%
West Virginia: 7.75%

Groups Positively and Negatively impacted: Corporations with more than $100,000 of taxable income would see a rate reduction. Negatively impacted would be groups relaying on the General Fund.

Revenue Impact: Negative $9.0 million if adopted in conjunction with the remaining recommendations.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	N

PROPOSAL: Add back management fees in the calculation of the corporate income tax base.

Note: This was a proposal from both the Consultants to the Commission and the Department of Revenue.

Background information: This proposal would prevent abuse of management fees that reduce Kentucky income taxes. A frequent aggressive tax planning device under the corporation income

tax law is the use of intercompany transactions related to intangible assets, which greatly reduces income that would otherwise be taxable. One strategy used is to inflate inter-company intangible expenses or management fees paid to an affiliate that is domiciled in a state that does not tax income. In other words, a Kentucky taxpayer claims the inter-company expense as a deduction on their Kentucky return. In turn, the affiliate that receives the payment is not taxed on that income in their state of domicile. By applying the requirements that already exist for intangible interest expenses and intangible expenses to management fees, this would strengthen management fees add-back language.

Other states: Illinois, Ohio, Tennessee and West Virginia require unitary combined reporting, which eliminates the deduction of management fees by including both the recipient and payer of the management fees in the combined return. Indiana provides that management fees create nexus for the recipient. Virginia disallows management fees unless the taxpayer can substantiate that the management fees are necessary and reasonable.

Groups positively and negatively impacted: Positively impacted – Corporations currently paying Kentucky income tax on management fees would benefit from a level playing field. Negatively impacted – Large multi-state, vertically integrated corporations that utilize inflated management fee deductions to reduce their Kentucky corporation income tax liability.

Revenue Score: Up to $15 million increase to the General Fund per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	N

PROPOSAL: Change the current three-factor apportionment rule to implement single factor apportionment based solely on sales.

Note: This is a proposal from the Consultants to the Commission.

Background Information: Apportionment is the method of determining the portion of corporate income or pass-through entity distributive share income taxable in a state in which the corporation or pass-through entity is doing business. In Kentucky, a 3-factor formula of sales, property and payroll is used to apportion a multi-state corporation's or pass-through entity's income to Kentucky to compute income tax. The sales factor is double-weighted. A change to a single factor apportionment based on sales only has been utilized by other states to assist economic development. If such a change was adopted in Kentucky, the apportionment formula would become Kentucky sales divided by total sales. Single-factor apportionment has been suggested as an additional tool for industrial recruitment.

"…a single factor apportionment method would be a better reflection of business conducted within the state. I would not penalize a business for creating jobs…"

—JESSICA CARLSON, PADUCAH

The change to single factor apportionment is primarily done to preserve or add jobs. Some corporations will pay more and some will pay less in Kentucky if single factor

apportionment is adopted. Some states limit the single factor based on sales to manufacturers. Other states allow the single factor based on sales as an election.

In the formative years of apportioning income, all states placed essentially equal weight on the three factors. Further, states have traditionally sitused sales of goods to where the market is located (on a destination basis). As a result, there has been a strong tendency to increase the weight on sales in the formula, which moves the tax towards a sales tax at a rate that depends on the profitability of the corporation. Kentucky double weights sales (puts 50 percent weight on the sales factor) in the formula. At least 14 states now use single factor apportionment based on sales and another four or more states have greater sales weight than Kentucky, but do not have single factor apportionment. Movement to single factor sales apportionment standard for taxation of the corporate income tax has been justified as a way to reduce taxation of production because the tax becomes linked to the amount of sales in a state and not the amount of employment, investment or production. Changes in the apportionment formula weightings have no implications for a firm that produces and sells its entire product in Kentucky since apportionment only applies to multi-state businesses.

The effects of increasing the weight on sales and decreasing them on employment and production in a state depend on the net of several factors. Greater emphasis on the sales factor raises the tax on purchases by instate buyers (some of whom are businesses producing in the state) which presumably discourages buying (or at least raises the costs for corporations to sell) in the state by both businesses and consumers. On the other hand, lower weights on property and payroll reduce the costs of hiring workers and using physical capital in the state. The net effect is an empirical question. Research generally finds that state economies are stimulated by greater emphasis on the sales factor (moving towards a destination tax), but the effects on individual states depend on specific characteristics of the region where the state is located.

Assuming no change in purchasing patterns, increasing the weight on the sales factor means more tax revenues will be remitted by firms that produce relatively less in a state than they sell and the reverse for firms that produce more than they sell. The effect on aggregate revenue depends on the net effect of the two groups of firms plus any influence on firm and consumer behavior as the tax structure is altered. The overall research has somewhat mixed results with some suggesting more revenues and some less revenues.

Groups positively and negatively impacted: Multi-state companies with a significant physical presence in Kentucky that include lots of payroll and property will see a significant tax savings. This includes large manufacturers and others that have a lot of plant, equipment and employees located here that also have a small percentage of their U. S. sales in Kentucky. A corporation that is headquartered here would benefit from a single sales factor. Companies with little physical presence and significant sales in Kentucky will pay more income tax under this proposal.

Other States: Approximately 18 states have changed from the standard 3-factor formula to a single-factor formula based on sales.

Revenue Score: $110 million loss to the General Fund per fiscal year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
	+	–	–	+

PROPOSAL: Change the existing cost-of-performance based formula for apportioning sales to incorporate a destination sourcing for services.

Note: This is a proposal from the Consultants to the Commission.

Background information: Sourcing of service revenues relates to determining the numerator of the sales factor portion of the corporation income tax apportionment factor. The three factor apportionment formula is based on sales, property and payroll. The apportionment factor computation is required for corporations taxable in this state and taxable in another state.

Current law requires service revenue to be sourced based on cost of performance. Under the current cost of performance rule, a sale is assigned to Kentucky if the majority of the service's cost is performed in Kentucky. Under a market sourcing approach, only services with a Kentucky end destination will be assigned to the numerator of the Kentucky sales factor as a Kentucky sale. Switching to market-based sourcing could result in more litigation than currently occurs under cost of performance.

The limited liability entity tax also is impacted by this issue as multi-state service corporations determine their limited liability entity tax base by using the numerator of the Kentucky sales factor from the corporation income tax apportionment factor computation.

Other states: Illinois and Ohio have adopted market-based sourcing. Indiana, Missouri, Tennessee, Virginia and West Virginia source service revenue based on cost of performance.

Groups positively and negatively impacted: Positively impacted – service businesses whose operations are primarily in Kentucky but with substantial sales sourced out of Kentucky. Negatively impacted – service businesses whose operations are located primarily outside of Kentucky and provide services to Kentucky customers.

Revenue Score: The fiscal impact is negative $10 million, if accompanied by single factor apportionment.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	–	–	+

PROPOSAL: Amend the small business standard from $3.0 million to $1.0 million and maintain the dollar-for-dollar phase out for gross receipts or gross profits to $2.0 million.

Note: This is a proposal from the Consultants to the Commission.

Background information: From the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants: "Kentucky made a number of changes in its corporate tax structure in 2005 and 2006. Like most states, Kentucky did not revise its tax statutes when it legislated the LLC, in 1994, as a possible organizational structure and later imposed the corporate income tax on LLCs. Kentucky also enacted a minimum tax as a percent of gross receipts as part of the corporate income tax structure. Subsequently, the limited liability entity tax (LLET), which is levied on all firms with limited liability including C-corporations, was enacted and LLCs were exempted from the corporate income tax. The LLET imposes the minimum of 0.75 percent on profits or .095 percent of gross receipts. Companies paying the corporate income tax are permitted a non-refundable credit against the LLET for corporate income taxes that are paid. The LLET limits the extent of tax planning for Corporations and imposes a small tax on LLCs.

The revenue threshold in the LLET is relatively large. Currently, a minimum $175 tax is levied on limited liability entities with $3.0 million or less in revenues and the benefits are phased out through revenues of $6.0 million. Behavioral changes can be expected when certain taxpayers are omitted from the tax and the potential for distortions rises with the size of the threshold. For example, companies could seek to avoid the tax by splitting into multiple businesses, each operating just below the threshold. Vendors in certain industries, and particularly ones characterized by low productivity, will be most likely to operate below the threshold. LLET revenues are surely reduced significantly by the threshold. A larger threshold reduces the number of firms required to comply with the LLET, which essentially eliminates compliance costs for the firms and reduces the number of taxpayers that Kentucky must control. It is important to remember that the administrative costs for firms below the threshold are not eliminated since Kentucky still must do some audit of whether firms meet the minimum threshold for compliance and the possibility exists that firms will intermittently comply as they exceed the threshold some years and not others. The $3.0 million threshold means that 82 of percent limited liability entities pay the minimum $175 tax.

Other states: Ohio established a $1.0 million threshold for the CAT and a strong case can be made that this is too high. No country in the European Union allows a threshold above approximately $140,000. Few states have adopted LLET taxes, but the ones that do have a gross receipts threshold for small business that is much lower than Kentucky.

Groups positively and negatively impacted: Positively impacted – advocates for increased state revenue. Negatively impacted – business entities that previously qualified for the $175 minimum.

Revenue Score: +$13 million (based on lower the $3.0 million LLET threshold to $1.0 million and phase out the effects through $2.0 million).

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	–	+	+	N

PROPOSAL: Establish an angel investor tax credit program for certain investments in small businesses.

Background information: The proposed angel investor tax credit seeks to encourage capital investment in the Commonwealth by providing a new source of private working capital to higher-risk start-up companies. The primary focus is to provide working capital for targeted knowledge-based, high-tech businesses. Under this proposal, individual investors could apply for a non-refundable individual income tax credit for qualifying investments in small businesses engaged in activities that show a potential for rapid growth. The Angel Credit outlined here contains many of the same concepts as a pre-filed bill for the 2013 Session filed by Representative Simpson. 2012 House Bill 113 and 2011 House Bill 448 were similar bills that did not pass.

These bills and the proposal recommended by the Commission create an angel investor tax credit program that would share the existing cap of 40 million that has been allocated for the Kentucky Investment Fund Act tax credit. Once the combined cap between the angel investor tax credit program and the investment fund tax credit program is met, no more credit under either program would be approved. The Kentucky Economic Development Finance Authority would be responsible for approving applications for the credit. No more than $4 million in angel investor tax credit may be approved in a calendar year for all applicants. The total amount of the angel investor tax credit that may be issued to any individual investor will be no more than two hundred thousand dollars ($200,000). The amount of credit awarded will be equal to forty-percent (40%) of the amount of the qualified investment, if the principal place of business of the qualified small business is outside an enhanced incentive county or fifty-percent (50%) of the amount of the qualified investment, if the principal place of business of the qualified small business is in an enhanced incentive county.

Other states: Several states have angel investor tax credit programs. Georgia, Colorado, Hawaii, Illinois and Minnesota are states with an angel investor tax credit. Illinois is the only border state with an angel investor tax credit program. Indiana, Missouri, Ohio, Virginia and West Virginia have some form of an investment tax credit program.

Groups positively and negatively impacted: Positively impacted – small business start-ups that are engaged in new economy business activities. Also, individuals that are angel investors approved for the proposed credit will benefit from reduced individual income tax liabilities. Negatively impacted – no one, except possibly an investor whose application is denied for not meeting the program's qualifications. If the $40 million combined cap is exceeded at some future date, then investors denied the credit due to the cap will be negatively impacted.

Revenue Score: Only $6.5 million of the total $40 million tax credits authorized by the Kentucky Investment Fund Act have been taken since its inception on July 15, 1998. However, over $18 million in credits have been approved and are no longer available. While they may not have been collected by the approved entity yet, they remain allocated. The new proposal would certainly increase usage of the combined program. The preliminary estimate would be an annual General Fund loss of $3.0 million.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
–	+	–	–	N

PROPOSAL: Expand the state's R&D Tax Credit to human capital; cap the amount available; and require that it is approved through a governing body, such as the Kentucky Economic Development Finance Authority.

Background information: The Cabinet for Economic Development recently retained a third party consultant to develop a state-wide economic development strategic plan. One of the recommendations included in the strategic plan, titled Kentucky's Unbridled Future, was to expand on the Kentucky R&D Tax Credit. Sustainable growth is dependent on the ability to create an effective policy framework that can facilitate continuous innovation, among other factors. Innovation is arguably the result of research and development (R&D) activities. To spur R&D activity the state needs to incent firms and entrepreneurs to undertake long-term projects with greater confidence and reduced risks.

Kentucky currently has an R&D tax credit, but it is not consistent with what other states and professionals in the industry refer to as an R&D tax credit. The current tax credit is not part of an economic development program. It is a credit that is claimed directly on the tax return for "…constructing, remodeling, and equipping facilities in this state or expanding existing facilities in this state for qualified research and includes only tangible, depreciable property, and does not include any amounts paid or incurred for replacement property;".

The taxpayer may claim up to 5% of the total cost and the carry-forward is 10 years.

Currently many states offer an R&D tax credit similar to the federal tax credit for R&D. The federal tax credit is a dollar-for-dollar credit against federal tax. R&D tax credits are available to any company that increases its qualified research spending: brand new companies, existing companies embarking on R&D for the first time or established companies expanding their R&D budget are all eligible.

The federal credit as well as state credits modeled after the federal credit, allow recovery of operating expenses and research activity expenses, including in some cases salaries, payments to engineers or consultants, payments for IP development and other activities. Most start-up companies do not have the funding to build a facility or renovate a facility so a credit for construction and remodeling is no help. Many are renting space or working out of incubators.

Also, larger existing companies conducting R&D are doing so in their existing facilities on an on-going basis without any new capital expenditures for the space they use. The current Kentucky credit is not beneficial to any of those.

This proposal would expand the state's current R&D Tax Credit to human capital and would cap the amount available to $4 million. In order to ensure appropriate compliance with the rules of the program, it would be overseen and approved through some sort of governing body, such as the Kentucky Economic Development Finance Authority.

Sources: The CPA Journal, a Publication of the NY State Society of CPAs. Anthony Billings, PhD; Milken Institute; The Information, Technology and Innovation Foundation website at www.ITIF.org; 2010 Journal of Accountancy.

Other states: Other states that have an R&D tax credit usually mirror or are very similar to the federal R&D tax credit. As of 2006 there were 38 states that had R&D credits linked with the federal R&D tax credit, allowing firms to take a 20 percent credit on increased R&D funding. Since then, the count of states with R&D credits has varied between 35 and 40 and the exact number of states is unknown. However, Indiana, Ohio, and Illinois have R&D credits modeled after the federal. There does not appear to be a similar credit available in Tennessee.

Groups positively and negatively impacted: It would be beneficial for Kentucky to get a reputation as a state that values and encourages R&D so that university graduates will be motivated to stay here and commercialize their research concepts. It is also beneficial to develop industry clusters by having existing industries (e.g. automotive) developing new technologies that will draw new companies in that industry as well as suppliers. The only known negative impact would be the cost to the General Fund.

Revenue Score: This proposal would be a new tax credit and would be negative to the General Fund. As proposed with a cap on credits taken, the annual fiscal impact would be $4 million. Establishing a baseline of current R&D activity would be an administrative burden, but not insurmountable.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	**Competitiveness**	**Elasticity**	**Adequacy**	**Simplicity & Compliance**
–	+	–	–	–

PROPOSAL: Fully decouple from the deduction for U.S. production activities (QPAI).

Background information: This proposal intends on eliminating the deduction that applies to both corporations and individuals. Previously, section 114 of the Internal Revenue Code excluded "extraterritorial income" which constituted "qualifying foreign trade income" under former section 941 from income. This encouraged U.S. businesses to export. However, that section was ultimately held to be a prohibited export subsidy by the World Trade Organization, and repealed. To offset the loss of this benefit, Congress enacted Section 199 regarding qualified production activities income (QPAI). QPAI is defined as the portion of taxpayer income which is

equal to the excess of the taxpayer's domestic production gross receipts over the sum of the cost of goods that are allocable to such receipts and other expenses, losses or deductions which are properly allocable to such receipts. The effect of this law is to encourage domestic production. Manufacturers who qualify can deduct nine percent of their QPAI on their federal return.
Several states allow this deduction at the state level. Kentucky adopted the deduction for U.S. production activities for tax periods beginning on or after January 1, 2005. It largely follows the federal deduction with the computation rate capped at six percent.

Other states: At least 19 states do not allow this deduction. Approximately 20 states allow the deduction in the same amount as the federal deduction.

Groups positively and negatively impacted: Those currently receiving the deduction would be negatively impacted. If the deduction is eliminated, there would be an increase to the General Fund.

Revenue Score: A General Fund increase of approximately $4.0 million per year will occur based on the deduction amount claimed on 2010 returns.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
–	–	+	+	+

SALES AND EXCISE TAXES

Background information

The tax base for the sales tax is gross receipts derived from both retail sales of tangible property and sales of certain services to the final consumer in Kentucky. The tax base for the use tax is the purchase price of tangible personal property for storage, use or other consumption in Kentucky. Sales and use taxes are imposed at a rate of six percent of gross receipts or purchase price, and generated $3.052 billion in revenue for the state Fiscal Year 2012, comprising 33.6 percent of General Fund receipts.

The cigarette excise tax, the cigarette surtax and the tax on other tobacco products generated $276.5 million in Fiscal Year 2012.

According to the report from the consultants to the Commission, "At 6%, Kentucky's general sales tax ranks fifth among the 13 states and is the median of sales taxing states." The consultants also noted that, "Kentucky's general sales tax, like that of other states, is regressive…As alcohol, tobacco, and gasoline are all larger shares of income for lower-income households taxes on this goods are regressive as well."

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Apply sales tax and transient room taxes to entire hotel accommodation price.

Note: This is a proposal from the Department of Revenue.

Background information: Changes in the accommodation business environment via online sites makes clarification a must in regards to receipts subject to local and state transient room tax. This clarification will include all amounts paid for staying in a Kentucky hotel or similar accommodation. Currently, any amounts charged or retained by online travel companies for their services are not included in the tax base for the state and local transient room taxes. This legislation would plug the gap in local and state room taxes created by the hotel intermediary companies, or HICs (Expedia, Orbitz, Travelocity, Priceline, etc.), that receive receipts from their transactions with hotel and accommodations providers. The general consumer reserving hotel rooms through an HIC is paying one price for the hotel room. This total should be subject to said taxes.

Other states: New York, Alabama, Pennsylvania, North Carolina, Missouri, Florida and the District of Columbia, among others, have seen litigation in this area with mixed results. Ohio had attempted to impose its current Transient Occupancy Tax but the U.S. District Court found the online travel companies not liable. The Multi-state Tax Commission is working on a model statute to address this issue.

Groups positively and negatively impacted: Positively impacted – Those that will benefit from increased transient room tax receipts such as local tourism development districts and municipalities. Negatively impacted – Hotel intermediary companies, also known as online booking agents.

Revenue Score: An increase of $4-5 million per year in General Fund tax receipts.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

PROPOSAL: Broaden the sales tax to selected services, with the following principles:

- Household-consumption based;
- Luxury items;
- Services that have a clear nexus to Kentucky;
- Tied to physical products already taxed;
- Services that have an inelastic demand, such that the imposition of the tax would result in minimal household or business shifting to avoid the tax; and
- Be sensitive to border state sales taxes.

Note: This is a proposal from the Consultants to the Commission.

Background information: From the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants: "Four rules should guide which services should be considered for taxation:

- The services should be primarily consumed by households.
- Kentucky service producers are not adversely affected in their ability to produce for Kentucky (or out-of-state) consumers.
- The services compete directly with other taxed goods or services.
- Administration and compliance costs are not prohibitively high. These costs are likely to be much lower when applying the tax to goods and services sold by operations already collecting the sales tax on other goods and services they provide."

Multiple states have considered increasing the taxation of services in order to combat fiscal shortfalls. Common justifications also include:

- Streamlining taxation. An example…admissions to all sporting events in Kentucky are currently tax exempt, but if we secured an NBA franchise in Louisville, those events would be taxed since they are professional.
- Remove distortions created by taxing goods only.
- Growing size of the service sector.
- Potential to lower the rate if the base is sufficiently broadened.
- General tax on consumption, which promotes fewer economic distortions.

Other states:

25+ States tax these services:

- Short term automobile rental
- Long term automobile lease
- Commercial linen supply
- Service contracts sold at the time of sale of TPP.
- Sign construction and installation
- Software – modifications to canned program
- Trailer parks – overnight
- Billiard parlors
- Bowling alleys
- Cable TV services
- Taxidermy
- Auto service, except repairs, incl. painting & lube
- Automotive rustproofing & undercoating

20+ States tax these services:

- Software
- Direct Satellite TV
- Repair labor, generally
- Labor on radio / TV repairs
- Labor charges – repairs on goods
- Other fuel (including heating oil)
- Diaper service
- Commercial art and graphic design
- Membership fees in private clubs
- Installation charges
- Electricity
- Natural gas
- Health clubs, tanning parlors, etc.
- Laundry and dry cleaning services
- Admission to school and college sports events
- Landscaping services
- Typesetting service
- Gift and package wrapping service
- Extermination Services
- Automotive washing and waxing.
- Parking lots & garages
- Labor charges on vehicle repair
- Garment services
- Shoe repair
- Telephone answering service

"I would also recommend the idea that's been brought up by others to expand the sales tax to other services…Constant with the notion that taxation on ability to pay, I think certain services are low hanging fruit so to speak; limousine rides, country club dues, and so for me these are no brainers if you're looking for generating income."

—ERIC LEWIS, PRESTONSBURG

15+ States tax these services:

- Automotive storage
- Carpet and upholstery cleaning
- Maintenance and janitorial services
- Window cleaning
- Automotive road service and towing services
- Pinball and other mechanical amusements
- Pet grooming
- Security services
- Installation charges – other than seller of goods
- Marina Service (docking, storage, cleaning, repair)
- Swimming pool cleaning & maintenance
- Coin operated video games
- Fur storage
- Armored car services
- Private investigation (detective) services
- Limousine service (with driver)
- Labor charges on repair of aircraft
- Labor – repairs to commercial fishing vessels
- Labor – repairs or remodeling of real property

10+ States tax these services:

- Mini –storage
- Software services
- Carpentry, building trades
- Household goods storage
- Cold storage
- Funeral services
- Water softening and conditioning
- Credit information, credit bureaus
- Information services
- Gross income of interior contractors
- Exterior construction service (grading, excavating, etc.)
- Water delivery
- Swimming pool cleaning & maintenance
- Coin operated video games
- Fur storage
- Armored car services
- Private investigation (detective) services
- Limousine service (with driver)
- Labor charges on repair of aircraft
- Labor – repairs to commercial fishing vessels
- Labor – repairs or remodeling of real property

Groups positively and negatively impacted: Positively impacted would be advocates for increased state revenues. Negatively impacted would consumers of the newly-taxed services.

Revenue Score: If the 2008 proposal from the Kentucky House of Representatives was adopted, the score would be approximately $106 million. If the proposal from the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants were to be adopted, the score would be $176.4 million. These services from the consultant's report are:

Personal Services
Funeral homes and funeral services
Industrial launderers
Beauty salons
Drycleaning and laundry services (except coin-operated)
Linen supply
Parking lots and garages
Cemeteries and crematories
Other personal care services
Coin-operated laundries and drycleaners
Pet care (except veterinary) services
Diet and weight reducing centers
All other personal services
Barber shops
Photofinishing laboratories (except one-hour)
Nail salons
One-hour photofinishing

Automotive Repair and Services (non-commercial)
General automotive repair
Automotive body, paint, and interior repair and maintenance
Automotive oil change and lubrication shops
Car washes
Automotive glass replacement shops
Other automotive mechanical and electrical repair and maintenance
Automotive transmission repair
All other automotive repair and maintenance
Automotive exhaust system repair

Other Residential and Consumer Repair Services
Appliance repair and maintenance
Other personal and household goods repair and maintenance
Consumer electronics repair and maintenance
Home and garden equipment repair and maintenance
Reupholstery and furniture repair
Footwear and leather goods repair

Amusements and Recreational Services
Remediation services
Fitness and recreational sports centers
Golf courses and country clubs
All other amusement and recreation industries
Marinas
Bowling centers

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	–

PROPOSAL: Exempt mail charges for direct mail from sales tax.

Note: This is a proposal from the Department of Revenue.

Background information: The Streamlined Governing Board has taken many concerns of the direct mail industry under advisement and amended the Streamlined Sales and Use Tax Agreement (SSUTA) accordingly. Some of these changes. now reflected in Kentucky tax code with the term "direct mail" defined in KRS 139.010(10) and sourcing provisions for various categories of direct mail specified in KRS 139.777, provide burden of proof relief for direct mail retailers. The administrative exemption provisions of the SSUTA allow a direct mail vendor to push the tax payment and reporting responsibility to its customers if a certificate is obtained at the time of sale. The industry continues to argue for adoption of additional carve outs available in the SSUTA that provide an exclusion from gross receipts subject to sales tax. Typically the delivery charge is more than the print cost.

"By not exempting postage from being taxable in all cases, I find it very difficult to justify to my customers why they should do business with me versus my competitors in Ohio."
—DEBBIE SIMPSON, HIGHLAND HEIGHTS

Current Kentucky sales tax law applies to any delivery charge to an address in Kentucky. This includes postage costs passed on to the business customer ordering the direct mail. This treatment is the same for any tangible personal property sold at retail that includes a delivery charge. The most recent change in the SSUTA allows member states to choose whether to exclude various component charges for direct mail (postage, delivery and handling) from the definition of gross receipts subject to sales tax. The proposal would exempt mail charges for direct mail from the sales tax. If Kentucky adopts this optional carve out, it will reduce General Fund receipts accordingly.

Other states: The border states of Ohio, Indiana, Illinois, Missouri and West Virginia treat these charges in the same manner as Kentucky. Tennessee exempts handling, transportation, shipping and postage charges for direct mail products only; Virginia exempts only postage. A handful of states exempt shipping, handling and postage charges for all tangible products including direct mail. Of the 24 SSUTA Governing Board states, eight states, including Kentucky, treat shipping,

handling and postage charges for direct mail as taxable amounts if included in the sales price of printed material. Ten states exclude these referenced charges only for transactions involving direct mail. Two states exclude shipping and postage but not handling charges for all taxable transactions. One state excludes only postage.

Groups positively and negatively impacted: Positively impacted – the commercial direct mail industry (in state and out of state entities) that has product delivered to households in Kentucky. Out of state printers selling into Kentucky are required to charge tax on their delivery charges for sales of product into Kentucky in the same manner that resident printers are required to do. Current law does not put Kentucky-based direct mail providers at a disadvantage as all business entities providing both printed material and mailing services must treat product mailed to recipients in Kentucky in the same manner. Household consumers will not be directly impacted because there is no charge to the recipient for direct mail advertising. Negatively impacted – the General Fund.

Revenue Score: A decrease in the General Fund of approximately $3.0 million annually, depending upon how many of the direct mail components are excluded from the definition of gross receipts (postage, delivery, and handling).

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	–	–	+

PROPOSAL: Impose a gross receipts tax of 1 percent on both residential and business utilities and dedicate additional revenues to the SEEK funding formula.

Background information: The proposal would impose a 1% gross receipts utility license tax on providers of utilities (residential and commercial), and dedicate the revenue to the SEEK funding formula. There is already a similar local tax of up to 3% being currently assessed in most jurisdictions whose funding is earmarked for schools. Economically, utilities are an ideal source of potential revenues due to several underlying conditions:

- The low cost of utilities allows a tax to be imposed without materially affecting the demand for utility services.
- Kentucky does not impose sales tax on residential utilities.
- Utility companies can pass along the small tax increase to the rate-payers (economic incidence).
- By using a utility gross receipts license tax rather than the sales tax, Kentucky would have more flexibility on rate-setting and no conflicts with SSUTA.

"Those of us who comprise of KEAT are here to say that our current tax structure simply cannot produce the constitutionally adequate resources necessary for our public schools. That the tax structure must be revised and enhanced. Our tax structure must change in ways that produce growing revenue as our economy grows. It must be adaptable to current and future economic realities not those of the past. It must produce adequate resources to meet the growing demands being placed on public schools."

—WAYNE YOUNG, BOWLING GREEN

Other states: Approximately 16 states tax residential electricity (including Illinois and Indiana), though in some cases under a special utility tax.

Groups positively and negatively impacted: Positively impacted would be advocates for increased state revenue. Negatively impacted would include utilities, utility customers (especially poor utility customers), and industries that consume a large percentage of power.

Revenue Score: Each percentage of the tax would result in a fiscal impact approximately $101.5 million in General Fund revenue. Revenue score will ultimately depend on the list of utility services that are taxed and the rate of taxation.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	N

PROPOSAL: Increase collection of out-of-state and Internet sales. Support federal legislation allowing states to require remote firms to collect sales tax.

Note: This is a proposal from the Consultants to the Commission.

Background information: For the past eleven years Kentucky and other states have been involved in a multi-state effort to streamline sales and use tax laws to simplify administration, filing and compliance with greater uniformity. Please refer to www.streamlinedsalestax.org/ for more information. Ultimately, the goal is for Congress to enact federal legislation granting states taxing authority over remote vendors. This taxing authority would be given only to states demonstrating a minimum level of simplification and uniformity. There are currently three bills in Congress addressing this issue. Sponsors of two bills are cooperating to develop a single consensus bill – the Marketplace Fairness Act, S.1832, and Marketplace Equity Act, HR.3179.

Since October of 2005, the Streamlined Sales Tax Governing Board has brought in more than $1 billion in sales and use tax to participating states from voluntary remote vendor collections. This collection figure is significant.

"I'm a tax professional and I think that the state's losing a lot of revenue by not having the mail order or the online and internet sales."

—KENNY BOOK, LEXINGTON

However, it is only a small portion of the total annual amount of uncollected sales and use taxes from remote vendor sales. The opposite side of remote vendor liability is consumer use tax liability on purchases from Internet and other remote vendors. Kentucky, plus 44 states and District of Columbia which impose a sales tax, also have a corresponding use tax directly imposed on purchasers for retail transactions. Kentucky law (KRS 139.310 and 139.330) makes it clear that individual consumers are liable for the 6% tax on their purchase price if the remote vendor does not collect the tax at the point of sale. The

Department of Revenue has several ongoing compliance programs to educate and encourage use tax reporting.

In summary, there are several strategies within Kentucky, collectively among states, and before Congress to address state and local Internet sales taxation issues. This is a critical issue for Kentucky-based merchants who directly compete with online merchants for the same customer base and for Kentucky's own tax base.

Other states: The current Streamlined Sales Tax Governing Board member states are: Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

Groups positively and negatively impacted: Positively impacted – Kentucky-based merchants. Current ecommerce growth patterns indicate that online retail sales will exceed brick and mortar sales by the year 2020. The lack of uniform sales tax treatment of retail sales by remote vendors regardless of the sales channel places Kentucky-based merchants at a distinct disadvantage. When Congress authorizes collection authority to states over remote vendors, competition among retailers will become more equitable. Consumers will have their use tax liability taken care of with collection by the vendor at the point of sale. Negatively impacted – remote vendors.

Revenue Score: Kentucky loses an estimated $130 to $200 million annually in uncollected sales and use taxes due to lack of remote vendor collection authority.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

PROPOSAL: Increase the tax rate on cigarettes to $1.00 and other tobacco products commensurate to the cigarette tax.

Background information: Many goods taxed through the excise methodology are considered to be "inelastically demanded", such that the percentage quantity response to a percentage price change is less than unity in absolute value terms. While border effects can alter the elasticity somewhat as it applies to gross state revenue estimates, modest increases in the tobacco taxes will yield positive revenues and arguably positive health outcomes.

- The current rate is 60 cents per pack (plus the sales tax). The proposal outline here is an increase from 60 cents per pack to $1.00 per pack.
- A similar increase in the ad valorem tax on other tobacco products (OTP) and the excise tax on moist snuff are also being recommended, increasing the rate from 15 percent to 22.5 percent on OTP.
- Estimates assume an inventory or floor tax. Past experience has shown hoarding behavior by consumers. An inventory tax would require any seller of cigarettes to file a floor tax return that includes an inventory of all Kentucky tax stamps in their possession on the

effective date of the excise tax increase. Sellers would be required to remit the difference between the new and old rates for every pack of cigarettes in their inventory. States that have failed to enact a floor tax with their excise tax increases have had lower than expected yields due to hoarding packs stamped at the lower rate.

Other states:

National average:	$1.46 per pack
Illinois:	98 cents
Indiana:	99.5 cents
Kentucky:	60 cents
Missouri:	17 cents
Ohio:	$1.25
Tennessee:	62 cents
Virginia:	30 cents
West Virginia:	55 cents

"There is a direct correlation with youth prevalence and the price of cigarettes and I really do want to emphasize the impact on pregnant women because here in Kentucky, we have a 24% rate of smoking among pregnant women--considerably higher than the national average. The national average is 10% of pregnant women who smoke."

—AMY BARKLEY, PADUCAH

Groups positively and negatively impacted: Positively impacted entities include: Advocates for healthier lifestyles through smoking cessation; Youth advocates, who contend that higher pack prices lead to a more elastic response of young smokers; Beneficiaries of the higher tax revenues

Negatively impacted entities include smokers, users of other tobacco products, tobacco wholesalers or retailers that find it difficult to pass wholesale price increase to the consumer, and tobacco growers. The impact on growers would be very minor since the impact of a modest tax increase in one state would not create a large drop in the demand for burley or flue-cured tobacco.

Revenue Score:

- Raise the Cigarette Tax to $1.00 per Pack .....$100.0 Million
- OTP Tax Increase to 22.5 Percent .....$10.0 Million
- Inventory Tax (one-time)…….$22.4 Million

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	–	+	+	N

PROPOSAL: Repeal the distilled spirits case sales tax.

Note: This is a proposal from the Department of Revenue.

Background information: The distilled spirits case sales tax was enacted long ago and generates very little money, typically less than $150,000. The other types of alcohol – beer and wine – do not have a similar case sales tax. All other levies on alcohol in Kentucky are uniform

across the different types of alcohol beverages. The distilled spirits case sales tax costs approximately $10,000 to administer.

Other states: Other states impose various levies on alcohol, but we could find none that generate such a low amount of receipts as the Kentucky distilled spirits case sales tax.

Groups positively and negatively impacted: Positively impacted would be distilled spirits wholesalers. Negatively impacted – unknown.

Revenue Score: Loss to the General Fund of approximately $100,000 per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	N	–	+

PROPOSAL: Restore Cigarette Rolling Papers Tax.

Note: This is a proposal from the Department of Revenue.

Background information: This tax was passed by both chambers of the Kentucky General Assembly but later stricken by the courts due the fact that it was delivered to the Governor past the midnight hour on the final day of the legislative session. This tax would have brought in roughly $750,000 a year. The tax could be re-enacted at an increased rate to help compensate for the loss of excise tax to cigarette rolling machines. Another option would be to amend the Other Tobacco Products Tax to include cigarette papers and tubes as Other Tobacco Products at the prevailing ad valorum. If re-implemented, infrastructure is already in place to collect the tax. The option of including cigarette papers and tubes into the definition of other tobacco products would be easy to implement. The downside of the second option would be lower tax revenues. Any action on this issue should probably be rolled into general tobacco excise tax reform.

Other states: Surrounding states have various methods of taxing tobacco products. Several aspects of surrounding states' statutes have been used in developing legislation to close loopholes in Kentucky's statutes. Tennessee taxes little cigars as cigarettes and West Virginia is attempting to treat commercial cigarette making machines at retail locations as manufacturers.

Groups positively and negatively impacted: Positively impacted – Kentucky and anyone who benefits from an increase in tax receipts. Negatively impacted – Sellers (resident and nonresident wholesalers) who report the tax and consumers of cigarette papers.

Revenue Score: The fiscal impact of this proposal if enacted is an $800,000 increase to the General Fund in the first year, then $1 million per year thereafter.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	–

PROPOSAL: Exempt the sales and use tax on certain equine products to support the signature equine industry.

Background information: The equine industry has long been seen as the signature industry of Kentucky. Kentucky's equine industry is comprised of the commercial farms, training centers, show arenas, and race tracks that are engaged in horse-related activities such as breeding, sales, training, racing, showing, boarding, and equine-assisted therapeutic and learning programs. It is imperative to understand that Kentucky's equine industry encompasses more than Thoroughbreds, but includes all horses of all breeds and uses.

The Kentucky Thoroughbred breeding and sales component is considered the strongest in the world with all the infrastructure (stallions, sales facilities, mare management, equine veterinarians, bloodstock agents, transportation services) required to support the industry within a compact geographic area. The significance of this domination of the Thoroughbred industry accounts for the prestige of a Thoroughbred foal bred and born in Kentucky.

The Kentucky horse industry has been facing significant pressure from numerous states that offer significant incentives for the breeding and racing of horses. States with alternative gaming at race tracks are vying for a greater share of Kentucky's equine business. Pennsylvania, Louisiana, Indiana and West Virginia are already attracting Kentucky horsemen. Additionally, new gaming initiatives in New York, Maryland, Florida and Ohio create additional pressure on the Kentucky equine industry with increased purses and breeding incentives.

To help the Kentucky equine industry remain competitive, numerous proposals have been made to expand the sales tax exemptions for the raising of livestock to include equine related agricultural expenditures. Tangible personal property utilized for equine use that could be exempt includes: hay, feed, feed additives, watering systems, equine grooming supplies, straw, seed and fertilizer applied to pastures, etc.

"We'd like to encourage you to reconsider examining sales and use tax on many agricultural products used by Kentucky's signature horse industry. Many people think of the signature horse farm, that's not who represents the backbone of our industry. Those are a few. The net margins are small; they're the farms you don't see from the road sides more often than not. Those horses are leaving and when they leave us they don't necessarily ever come back. They go to other places where it's more profitable and more competitive."

—BOB QUICK, LEXINGTON

Groups positively and negatively impacted: The Kentucky equine industry would be the primary beneficiary of the proposed expansion of the sales tax exemption for tangible personal property for equine use. However, many businesses in Kentucky provide specialized inputs and services to the equine industry, and many of these firms would also benefit from the expansion of the sales tax exemption for equine related tangible property.

Other states: Kentucky is in a unique situation where our signature industries include the breeding, training and racing of many horse breed. Few other states place the same priority on their equine industry.

Revenue Score: Previous proposals have been estimated to have a fiscal impact of approximately $14.4 million per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	–	–

PROPOSAL: Apply sales tax to pre-written computer software made available for access without a download.

Kentucky currently taxes prewritten computer software 1) purchased off the shelf in the store, 2) loaded by the seller on the customer's computer with no physical disk left with the customer and 3) downloaded online to the customer's computer. This proposal is to clarify that tax applies also to access and use of the equivalent software product where the object of the transaction is to obtain and use the software even though possession of the software is maintained by the seller or a third party.

Prewritten computer software is included in Kentucky's definition of tangible personal property. Kentucky's 6% sales tax applies to "the retail sale of tangible personal property, ***regardless of the method of delivery***." Some states with similar language already apply sales tax to charges for remote access to pre-written computer software.

This proposal will clarify and preserve Kentucky's existing tax base on the retail sale of prewritten computer software in similar fashion to previous action addressing the download of computer software and taxation of digital products in the same manner as their tangible counterparts (House Bill 293 passed in 2003 GA to preserve the base on electronic downloads and House Bill 347 passed in the 2009 GA to update language to address digital property).
In July 2010, Amazon reported its sales of e-books outsold sales of hardbacks. The company crossed the same threshold with paperbacks in January 2011. According to one forecaster, ebook sales are expected to generate $9.7 billion worldwide in 2016, more than three times the $3.2 billion the category is expected to generate this year. Through November of the 2012 holiday shopping season, the top product category of Digital Content & Prescriptions (which includes digital book, music and video downloads) has grown by 25% from last year. Software is now following the same path. The global market for cloud computing will grow from $41 billion in 2011 to $240 billion in 2020. By 2015, an estimated 24% of all new business software will be sold under this model of remote access.

KRS 139.200 imposes the 6% sales tax on gross receipts from retail sales of tangible personal property (covers software sold through traditional channels) and digital property. The proposed amendment will add charges for the right to access and use prewritten software which is

equivalent to that which could be obtained from a retailer and used independently by the end user. Excluded from the charges for the right to access and use prewritten computer software are separately stated data processing and information services.

The following states currently tax remote access to computer software: Indiana, Massachusetts, Michigan, New York, Ohio, Pennsylvania, South Carolina, Texas, Utah, Washington and West Virginia.

Groups positively and negatively impacted: Positively impacted – Software vendors which deliver product via download, disk, etc will have equity with competitors that use a cloud platform to provide the same product. Negatively impacted – Those who currently pay no tax by switching to the cloud platform will have to pay their fair share to preserve the tax base attributed to retail sales of prewritten computer software.

Revenue Score: Indeterminable increase to the General Fund.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	N

PROPERTY TAXES

Background Information

Property is taxed in Kentucky in accordance to Section 172 of the Kentucky Constitution:

> All property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at the price it would bring at a fair voluntary sale; and any officer, or other person authorized to assess values for taxation, who shall commit any willful error in the performance of his duty, shall be deemed guilty of misfeasance, and upon conviction thereof shall forfeit his office, and be otherwise punished as may be provided by law.

The Constitution was amended in 1998: Notwithstanding the provisions of Sections 3, 172, and 174 of this Constitution to the contrary, the General Assembly may provide by law an exemption for all or any portion of the property tax for any class of personal property.

Property taxes make up 20.6 percent of the distribution of state and local tax collections for Kentucky, compared with 33.4 percent for all the states as a whole; they make up 5.3 percent of the distribution of state tax collections, compared 1.8 percent for all states as a whole.

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Create an income tax credit for the bourbon industry to offset the property tax on stored barrels of bourbon, without reducing local property taxes to school districts or local communities.

Background: Income tax credits in lieu of barrel tax.

"You see, there are seven different taxes on every bottle of bourbon…and one of those is the ad valorem property tax, commonly called a barrel tax…is a tax that no other alcohol manufacturer pays in the United States or around the world, putting our bourbon distilleries at a competitive disadvantage in the global market place and restricting further growth right here at home."

—ERIC GREGORY, LEXINGTON

- The distilled spirits industry (especially bourbon) has become a growing signature industry in Kentucky. The Commonwealth has made substantial investments in the Kentucky Bourbon Trail through our Tourism, Arts and Heritage Cabinet.
- Kentucky taxes distilled spirits held in inventory. Specifically, the barrel tax is taxed at the state level as well as full local rates (including school taxes).
- For tax year 2011, local collections were approximately $12.0 million with an additional $1.0 in state collections.
- The proposal is to provide a tax credit against the corporation income tax equal to the amount of distilled spirits ad valorem tax (state and local) timely paid in the taxable year, which the industry would reinvest in capital improvements to their facilities.

Groups positively and negatively impacted: Positively impacted groups include distillers who store and age bourbon in Kentucky. Distillers will continue to pay the property tax but will receive an income tax credit that equally offsets this liability. Schools and other taxing districts will also win; they will continue to receive the property tax payments and their local distillers will be held harmless to paying the taxes. Groups negatively impacted would include anyone impacted by the loss of General Fund dollars due to the cost of the income tax credit.

Other States: Kentucky is in a fairly unique position with a taxation on most tangible property, even though bourbon is a signature industry with very large quantities of distilled spirits being held in storage. When exploring the taxation of other states, details prohibit the analyst from generalizations since each state has a unique mix of local versus state taxes, not to mention different assessment protocols.

Revenue Score: $12.6 million in the first year. The tax should grow over time as the Kentucky distillers presence is preserved.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	N	N	+

PROPOSAL: Exempt inventory from state property tax (merchant's inventory, manufacturers finished goods, and goods stored in warehouse.

Note: This is a proposal from the Consultants to the Commission.

Background information: Kentucky taxes several types of inventory under the property tax. Inventory is taxed at different rates. The chart below shows the total assessed value and the amount of state property tax generated from inventory for 2011. There would be an impact upon state and local coffers if inventory were to be totally exempted with the biggest impact upon local revenues.

- Our border counties asked for consideration due to more favorable treatment of inventories held in other states.
- We selected the list we did because they had low rates (15 cents or below), and before 1998 we could not exempt classes of property.
- A change at the state level does nothing to alter local taxation of these properties.

Other Inventory with 5¢ state rate + Full local rates

	Assessed Value	Tax Liability
Merchants Inventory	5,710,441,269	2,842,511
Manufacturers Finished Goods	2,035,553,544	1,016,906
Goods Stored in Warehouse	1,120,146,746	559,844
Totals	8,866,141,559	4,419,261

Other states: Tangible personal property is exempt in Illinois, Ohio and Virginia. Indiana. Missouri and West Virginia tax tangible personal property at low rates. Tennessee taxes tangible property at various rates.

Groups positively and negatively impacted: All businesses within Kentucky would pay less property tax and would be positively impacted. The State would be negatively impacted.

Revenue Score: $4.4 million annual decrease to state revenues.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	+

PROPOSAL: Freeze the state property tax rate at 12 cents per $100 of value.

Note: This is a proposal from the Consultants to the Commission.

Background information:

- Subsequent to the Special Session of the General Assembly in 1979 and the passage of HB44, the Kentucky tax rate on real property has fallen from 31.5 cents per $100 in valuation to the 2008 level of 12.2 cents per $100. Before 2008, there were only two years where the rate did not decline. Since 2008, however, the state ad valorem rate on real property has remained at 12.2 cents for five consecutive years as the housing recession has led to flat or declining property assessments.
- The proposal adopted by the Tax Commission is to remove the annual rate setting process in favor of a stationary rate of 12 cents per $100 valuation.
- Over time, as property valuations resume long run growth patterns, the freezing of the rate should enhance elasticity, simplicity, and adequacy.

Other states: Kentucky is viewed as a low property tax state, both locally and state rates. A comprehensive analysis of states that allow flexible rates is currently being undertaken.

Groups positively and negatively impacted: As time elapses, the fiscal impact will become positive as property assessment re-equilibrate from the Housing Recession of 2007. A few entities would object to any changes in that taxation of real property, most notably the Kentucky Farm Bureau and potential real estate brokers.

Revenue Score: -$8 million initially but impact will be positive over time.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance

N	–	+	+	+

PROPOSAL: Clarify the identification of public service companies for taxation.

Note: This is a proposal from the Department of Revenue.

Background information: Adopting this proposal expands Kentucky's public service company tax code to include newly developing utility industries operating within Kentucky and to clarify the intent of the overall statute. Deregulation of industries and technological advances have spawned new types of companies that should be recognized as public service companies, which are subject to assessment by the Department of Revenue.

New companies to be added to public service company taxation include those generating power via wind, solar or other means. Also included are power marketing companies for any form of energy.

Other states:

- Illinois: Exempt. Commercial solar/wind electric generating companies are exempt from state & local personal property tax. Real property is taxable.
- Indiana: Taxable. Property taxation is essentially a local issue. Commercial solar / wind electric generating companies are subject to property taxation.
- Missouri: Taxable. Commercial solar / wind electric generating companies are taxable and centrally assessed.
- Ohio: Taxable. Commercial solar / wind electric generating companies are taxable as utilities and centrally assessed.
- Tennessee: Taxable. Commercial solar / wind electric generating companies are subject to property taxation, centrally.
- Virginia: Taxable.
- West Virginia: Taxable. Commercial solar / wind electric generating companies are centrally assessed as a utility and subject to state and local taxation.

Groups positively and negatively impacted: Positively impacted – state and local tax revenues. Negatively impacted – newly developing utility industries that will be subject to property tax.

Revenue Score: Unknown increase to state and local property tax revenues.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	–	+	N

PROPOSAL: Require reporting the rental space for documented watercraft/private airplanes.

Note: This is a proposal from the Department of Revenue.

Background information: Owners who rent space for mobile homes and out-of-state RVs are required to file an annual report with the PVA. This proposal would extend that requirement to those who rent space for documented watercraft and private airplanes. This would help to guarantee that documented watercraft and private aircraft are subject to ad valorem taxes.

Other states: Surrounding states handle the reporting and taxation of documented boats and private aircraft in different ways, with some exempting personal property completely.

Groups positively and negatively impacted: Positively impacted – local taxing districts and the state because reporting of documented boats and private aircraft would lead to greater compliance and more revenue even if tax rates are kept the same. Negatively impacted – owners of documented watercraft and private airplanes who rent space in Kentucky for that type of property.

Revenue Score: The fiscal impact is hard to determine because it would mean putting a dollar amount to an unknown (i.e., the total value of documented boats and private aircraft that are not reported).

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	+

PROPOSAL: Eliminate select negligible state property tax rates for tangible personal property, with an emphasis on classes or property subject to the "State Rate" only.

Note: This is a proposal from the Department of Revenue.

Background information: Kentucky tax rates for some personal property items are extremely low. Prior to 1998, tangible personal property could not be exempted from tax based on Kentucky Constitutional requirements. As a result, some personal property items were taxed at minimal state rates. A constitutional change, passed in 1998, gave the General Assembly authority to eliminate classes of personal property from taxation. The Department of Revenue proposes to eliminate state taxation on the following classes of property:

- Unmanufactured Agriculture Products in Holding (1.5 cents per $100)
- Non-commercial Aircraft/Watercraft (1.5 cents per $100)
- Foreign Trade Zone property (One-tenth of one cent per $100)
- Livestock & Farm Machinery in fluidized Beds Energy Facilities (One-tenth of one cent per $100)
- Manufacturer's Raw Materials, Goods in Process, Motor Vehicles held for Sale, Farm Machinery held for Sale, Salvaged Title Vehicles (5 cents per $100)

These taxes cost more to collect than they generate.

Other states: Tangible personal property is exempt in Illinois, Ohio and Virginia. Indiana. Missouri and West Virginia tax tangible personal property at low rates. Tennessee taxes tangible property at various rates.

Groups positively and negatively impacted: Positively impacted – CPAs and taxpayers who want simplification and consistency. Negatively impacted – Those taxpayers who will still pay tax on other types of tangible personal property.

Revenue Score: Negative $5 million to the General Fund.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	+

SEVERANCE TAXES

Background Information

The Commission reviewed several state severance taxes. The coal severance tax is levied on the gross value of the coal. Gross value is the amount received or receivable for the coal, or market value if the coal is consumed and not sold, less transportation expense. The coal severance tax rate is 4.5 percent of gross value with a minimum tax of fifty cents per ton and generated $298.3 million in Fiscal Year 2012, representing 3.3 percent of General Fund revenues.

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Eliminate the export credit under the minerals severance tax.

Note: This is a proposal from the Department of Revenue.

Background information: Current law allows a 100% credit against the gross value of exported limestone if a taxpayer exports 60% or more of the limestone severed in Kentucky. Those who sever Kentucky limestone and sell more than 40% to Kentucky-based customers are at a disadvantage compared with those who export the majority of minerals severed.

During the fiscal year ending June 30, 2011, more than $2.2 million in credit was claimed.

Other states:
West Virginia: Rate is $5.00 per $100 with no export credit given. There is an allowable credit for companies engaged in business activities of the reporting period. The credit is $500 yearly or $41.67 monthly and does not relate to exports.
Tennessee: A tax is levied upon the severance of mineral products from the earth and readied for sale. However, sales of all minerals for use outside Tennessee are exempt. Exempt sales do not need to be included in this return, but records must be maintained to support the exemption.

Groups positively and negatively impacted: Positively impacted – Counties that receive minerals severance tax receipts. Negatively impacted – Limestone companies that would no longer have the credit available.

Revenue Score: Eliminating the credit will increase General Fund revenues and increase the amounts allocated to counties with limestone mines. In FY2011, the amount of credit claimed was $2,224,700.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+		+	+	+

PROPOSAL: Clarify the definition of "gross value" under severance tax.

Note: This is a proposal from the Department of Revenue.

Background information: Coal severance tax and minerals severance tax is imposed on the severing or processing of coal or minerals. In the definition of "gross value" for computing the tax base, the reference to section 613(c) of the Internal Revenue Code needs to be removed from the severance tax statutes. The statutes state that "gross value" is synonymous with gross income from property as defined in section 613(c) of the Internal Revenue Code. Under the federal statute, gross income from property in this context means gross income from mining. The federal statute does not consider processing to be gross income from mining unless performed by an owner or operator of a mine. An argument can be made that processing performed by anyone else is not taxable because the amount of gross income from mining is zero, and thus, the amount of gross value will always be zero.

If no change is made, current coal severance taxpayers who are engaged in processing coal that they do not mine themselves may argue that their severance tax liability is zero.

Other states: For severance tax definitions, no surrounding state was found to include a reference to the internal revenue code as Kentucky does.

Groups positively and negatively impacted: Positively impacted – counties that receive severance tax funds. Negatively impacted – processors of coal and minerals in Kentucky who are not the owner/operator of the mine may argue that they are not subject to the tax.

Revenue Score: receipts reduction of approximately $3,200,000 in state revenues and $3,200,000 in local revenues will occur on an annual basis if the definition is not clarified.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

OTHER TAXES/ISSUES

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Impose the Pari-mutuel tax on advance deposit wagers made on live races conducted at Kentucky race tracks.

Note: This is a proposal from the Department of Revenue.

Background information: Kentucky residents currently can place a wager on horse racing via internet gambling sites without the wager being taxed under the pari-mutuel excise tax. The resident establishes an account with an entity that provides the opportunity to wager via the internet. The resident places money in the account (advance deposits) from which wagers are made. This modern type of wagering on horse racing has become more popular and enables the gambler to wager and watch from home as opposed to betting at a race track or simulcast facility. Wagers made via this modern method on live racing conducted at Kentucky race tracks is reducing the wagering handle on live racing that is the tax base for determining the amount subject to pari-mutuel tax on live racing; technology is eroding the tax base. Therefore, the Department of Revenue proposes to tax advance deposit wagers in a similar fashion as wagers made at licensed race tracks on live racing. DOR proposes a rate of one-half of one percent (.005)

Other states: Illinois taxes advance deposit wagers at 1.5%.

Groups positively and negatively impacted: Groups positively impacted – The equine groups that receive funds from pari-mutuel excise tax collected on live racing. Groups negatively impacted – Possibly tracks that conduct live racing if the advance deposit wagers push the total live wagering handle to an amount over $1.2 million.

Revenue Score: Approximately $6 million per year in additional pari-mutuel tax revenues are projected.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	N

PROPOSAL: Provide for a review every five years of all tax incentives and expenditures.

Background information:

The enacted biennial budget bill for the Executive Branch has required the preparation of a biennial tax expenditure report for the heads of all three branches of state government for over ten years. It details all tax expenditure items, meaning all exemptions, exclusions or deductions

from the base of a tax, all credits against a tax, deferrals of a tax, or preferential tax rates. Copies of the report are provided to all members of the General Assembly.

This recommendation calls on the Governor and General Assembly to review all tax incentives and expenditures every five years.

Other states:

- Iowa – Effective July 1, 2010, a legislative tax expenditure committee is created to annually review Iowa tax incentive programs.
- Oklahoma law provides an Incentive Review Committee to perform an annual comprehensive review of state tax incentives.

Revenue Score: Not applicable.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
NA	NA	NA	NA	NA

ROAD FUND ISSUES

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Stabilize fuels tax revenues to support highway funding by raising the floor of the average wholesale price for fuels taxes.

Freeze the statutory lower bound on the average wholesale price definition used in the calculation on the tax rate on motor fuels.

Background information:

- The gasoline tax in Kentucky is comprised of three components:
  - A variable rate, which is 9.0% of the Average Wholesale price (AWP is defined in statute). The AWP floor or minimum rate is currently set in statute at $1.786 per gallon, so 9% of that equals 16.1 cents per gallon.
  - A Supplemental Highway Tax of a flat 5 cents per gallon on gasoline and 2 cents per gallon on special fuel.
  - An Underground Storage Fee of 1.4 cents per gallon.
- All three taxes are paid at the wholesale level, but the taxes are ultimately, at least partially, passed to consumers at the pump through higher prices. (Incidence of the tax at consumer level).
- The Variable Rate component of the fuels tax has risen in each of the last 5 years as average wholesale prices have risen.
- By statute (KRS 138.210), the average wholesale price is limited to 10% growth per year. That equates to roughly a maximum tax rate increase of 1.5 cents per year (first increase was exactly a penny).
- The first two increases in the statutory AWP were memorialized in statute.
- In 2005, the statutory floor was raised to $1.22
- In 2006, the statutory floor was raised to $1.34

The proposal here is to freeze the minimum AWP at $2.616 per gallon (current fiscal year rate)

- Falling fuel prices could destabilize Road Fund since the tax rate on motor fuels is tied to the average wholesale price of motor fuels. See KRS 138.210 (10).
- AWP for purposes of setting the fuels rate is limited to a 10% annual increase.
- There is no 10% cap on reducing the AWP.
- In both the 2005 and 2006 legislative actions, the extra “pennies” of fuels tax preserved by the law changes were designated as “unshared”, with the end result being 2.1 cents of our fuels tax not being shared with locals.

Other states: Most states tax motor fuels. Most states have a mechanism that dictates a process for future rate changes. The inconsistency in the KY rate formula is that we have a 10% cap on increases but no 10% stop loss for reductions. This asymmetry seems rather unique, and

changing the process to eliminate the inconsistency would remove considerable risks on longer term construction projects that require adequate revenue in the future.

Groups positively and negatively impacted: Virtually all groups support road construction would support this measure. Kentuckians for Better Transportation highlighted this in their recommendations at the Fayette meeting. Opponents will be few at the moment as there will be no fiscal impact on this proposal for several years.

Revenue Score: No fiscal impact in the short run. Will help establish a workable base in the longer term.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	–	+	+	+

PROPOSAL: Reduce dealer's compensation on motor fuels tax from 2.25% to 1%.

Note: This is a proposal from the Department of Revenue.

Background information: Kentucky's motor fuels taxes are collected by licensed dealers. Dealers are allowed a compensation allowance that reduces the amount paid each month to Kentucky. This allowance compensates for dealers' expenses incurred for collecting and remitting the tax. Kentucky licensed motor fuel dealers receive a much higher compensation compared to surrounding states as well as the state vendor/wholesaler population at large. In many states a licensed dealer is required to share the compensation with retail gasoline vendors. In Kentucky no such sharing provision exists. Currently the entire 2.25% compensation is retained by licensed
dealers. Also of note, licensed dealers have until the 25th day of the following month to remit tax to Kentucky via monthly returns. This return due date provides float time of considerable value to licensed dealers. Because of technology advances, most motor fuels taxes are collected electronically before the fuel tanker leaves the terminal. This practically eliminates bad debt claims.

The current dealer compensation rate has not been adjusted to reflect these changes in technology that make reporting and filing compliance easier. Since 2008, the Department of Revenue has provided a web-based electronic filing and payment system to the dealer community. Training and implementation of the system was provided at no charge to dealers.
As a comparison, Kentucky has made legislative changes to the vendor compensation for sales and use tax.

Prior to July 1, 1990 the sales tax vendor compensation was two percent. Since July 1, 1990 the compensation rate has been 1.75% of the first $1,000 in tax ($17.50) and 1% of collections above $1,000. An overall cap per reporting period of $1,500 was initially set in place through the 2003 Budget Bill. The $1,500 cap was continued in two additional budget bills and was

permanently codified in 2008. The sales and use tax vendor compensation cap has generated an estimated $9.5 million increase to the General Fund.

Other states: Missouri allows 3.1% on gasoline and 2.1% on special fuels, but the supplier must pass on either 3% or 2%, respectively, to the distributor/retailer. Ohio has reduced its rates by 50% whereby dealers now get 1% instead of 2% they received in 1998. Virginia has reduced its previous 0.5% exemption to 0.005% and now gives a 1% allowance to licensed distributors and importers. Indiana allows 1.6% and Tennessee compensation is 1%.

Groups positively and negatively impacted: Positively impacted would be all who participate in and rely upon sound road infrastructure throughout Kentucky. Negatively impacted would be licensed gasoline and special fuel dealers (wholesalers).

Revenue Score: $17.5 million increase to the Road Fund in the first year. $21 million increase annually after that.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	N

PROPOSAL: Implement a trade-in credit for new car purchases that would equalize treatment for used vehicles and new vehicles.

Background information: Kentucky's motor vehicle usage tax is collected by county clerks when a vehicle is presented for registration. Unlike used vehicles, the retail price for new vehicles is not reduced by the amount of the vehicle(s) given in trade. Tax is based on total consideration given as attested to in a notarized affidavit or 90% of the MSRP if an affidavit is not available.
Legislation passed in 2009 allowed trade-in credit on new vehicles until June 30, 2011 or until a $25 million cap is reached. The legislation was effective September 1, 2009 with the cap being reached on August 16, 2010.

During implementation of the temporary credit, changes were made to the automated vehicle information system to track when the cap was reached. That computer system is being replaced by a new vehicle information system and a permanent trade-in credit allowance would require modifications to that new system.

Other states: In most states vehicles are subject to sales and use tax. Missouri, Illinois, Indiana, and Ohio all allow trade-in deductions on new vehicles.

Groups positively and negatively impacted: Positively impacted – new motor vehicle dealers and taxpayers who purchase a new vehicle and have a trade-in. Negatively impacted – the Road Fund.

Revenue Score: Based upon the temporary credit experience, there could be a minimum annual $34.0 million decrease to the Road Fund. On average, the Road Fund decreased $672.20 each time a vehicle was traded in on a new vehicle.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	N

LOCAL TAXATION ISSUES

According to the report from the consultants to the Commission, "…[P]roper evaluation of the state tax system cannot ignore the structure of local taxes in Kentucky nor should any reform efforts ignore the ramifications of changes in the state tax structure on local finances…Kentucky has a very centralized revenue system with 65% of state and local revenue collection being done by the state government. Local governments in Kentucky finance through very different revenue sources than most states. Kentucky local governments are less reliant on the property taxes, much more reliant in individual income (occupational license) taxes, and do not have the option to tax general sales taxes. Only 15 states do states not have the option to have a local general sales tax and in only 15 states do local governments have the authority to tax income."

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Amend Section 181 of the Constitution to allow a local general sales tax.

Note: This is a proposal from the Consultants to the Commission.

Background information: "From the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants: "The ability of local governments to use a general sales tax will give them more flexibility and stability in their revenue collections. However, for a number of reasons the state must impose some limitations and constraints on the imposition of local sales taxes".

"Kentucky should also grant cities the option of a small local sales tax to fund special projects. Cities all over the country provide their citizens with an option to determine the vision of their cities through local referenda."

—MAYOR GREG FISCHER, LOUISVILLE

- First, the local general sales tax must be collected by the state and it must be imposed on the same base. Independent collection would be costly and lead to significant problems with compliance. These criteria also follow the Streamline Sales and use Tax Agreement to which Kentucky is a full participating member.
- Second, another concern is the pyramiding of tax collections by having different local governments within an area– for example, counties, municipalities, and school districts in the same area – using different general sales tax rates. Collections by the state will significantly reduce the administrative concerns regarding multiple local entities but situsing the sales across local governments and multiple tax rate will increase the complexity for businesses and state tax collectors.
- A third consideration is what locality receives the tax revenue. Tax revenue will be collected at the point of sale but as much as possible our recommendation is that receipt of tax revenue be destination not source based. Thus if a good is ordered in one municipality but shipped elsewhere the tax revenue should be credited to the municipality where the good is shipped and presumably consumed. True destination taxation will only occur with goods that are shipped since the tax will be paid where possession of an item is taken if a person drives to a store in another county and takes possession in the other county.

"I urge you to help cities. They are hurting now."
—PADUCAH MAYOR BILL PAXTON

The state will need to impose limits on the rates that local governments can set. As discussed previously, a local sales tax will reduce state tax collections by decreasing sales in the state. This will be a particular concern for localities on state borders – high local sales taxes in these areas can be expected to reduce retail revenues and associated state tax revenues. Use of the sales tax by multiple types of local governments only compounds these concerns about the interdependent tax bases and the associated impacts on revenues.

Finally, it should be mentioned that a local option sale tax (LOST) requires a constitutional amendment. The Supreme Court has held that under Ky. Const. § 181 the General Assembly cannot delegate the power to levy excise taxes such as sales and use taxes to subordinate units of government such as cities and counties IC.C.C. Coal Co., Inc. v. Pike County, 536 S.W.2d 467 (Ky. 1976))."

Other states: Thirty-eight states allow a local general sales tax. Tennessee and Illinois allow a local general sales tax only. Ohio, Virginia and Missouri allow both local sales and local income taxes.

Groups positively and negatively impacted: Advocates for increased local government funding would be positively impacted. Negatively impacted would be anyone who purchases items under the local option sales tax. Retail outlets in border counties may also lose some sales since the higher local sales taxes would have the same impact as a price increase.

Revenue Score: A slight decrease to the General Fund due to reduced border sales. However, the fiscal impact will be mitigated depending on which jurisdictions that enact this proposal.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
–	–	–	–	–

PROPOSAL: Remove the HB44 recall provisions for local and school real property taxes.

Background information: Under the series of statutes collectively known as "House Bill 44," local taxing districts cannot set a real property tax rate that will produce more than a 4% increase in revenue – exclusive of revenue received from new property – without first having a public hearing and then going through a 45 day period during which a taxpayer recall petition may be filed. If a petition is filed, the taxing district has the option of adopting a tax rate that will provide a 4% increase in revenues. However, if the taxing district wants to continue in its efforts to set a rate that will produce more than a 4% increase in revenues, the rate is put to a vote at the next election.

This proposal would remove the recall provisions. Specifically, it would clarify that public hearings must still be conducted for rates exceeding the "4-percent" rate, but remove the recall provisions to permit greater local control in the setting of rates.

Other states: Very limited information was found on how local property tax rates are set in the states surrounding Kentucky. In Illinois, property tax revenues are limited to an increase of the lesser of 5% or the increase in the national Consumer Price Index. In Indiana, the local tax rates are subject to approval by the Indiana General Assembly and tax rates are capped at 1% of value for residential property, 2% of value for farms and 3% of the value of all other real property. West Virginia has maximum local tax rates established by law. In the other states the local tax rates are determined by various boards and commissions.

Groups positively and negatively impacted: Positively impacted – local and school taxing districts would be positively impacted by the removal of the tax rate limitations currently imposed upon them; however, there would likely continue to be enormous pressure on these districts to keep property tax rates in check. Negatively impacted – all real property owners could be negatively impacted by the removal of the property tax rate restrictions.

Revenue Score: There would be no State fiscal impact. At the local level, while removing the recall provisions for local and school property tax rates definitely would make it easier to raise these tax rates, there is no guarantee that the districts would do so. There is also no way of knowing how high a district may raise a tax rate.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	–	N	N	–

SIMPLICITY, COMPLIANCE AND TAX ADMINISTRATION

Background Information

The taxpaying community must understand the system of taxation and fully understand the need for and uses of tax revenues. And, as noted by Lori Flanery, Secretary of the Finance and Administration Cabinet, the frequent litigation of tax issues contributes to the complexity of Kentucky's tax code.

Commission Actions

The Commission voted to recommend the following proposals:

PROPOSAL: Allow non-renewal of professional licenses, driver's licenses and vehicle registration if taxpayers have exhausted all appeals and still refuse to pay state taxes to improve collections.

Note: This is a proposal from the Department of Revenue.

Background information: The Department of Revenue seeks to enact the following legislation:
1) Requires agencies, boards and commissions to deny the issuance of a license to an applicant when a delinquent tax debt exists to Kentucky based upon a Department of Revenue request;
2) Gives the Department of Revenue authority to revoke a Kentucky driver's license for the collection of delinquent tax debt. This includes motor vehicles, motorcycles, commercial driver's licenses, etc.; and,
3) Gives the Department of Revenue authority to work cooperatively with county clerks to deny issuance of a vehicle registration to any taxpayer who has an unpaid delinquent tax liability.

The Department of Revenue plans to use these methods only in instances where the taxpayer has due and payable (delinquent) tax debt, has not entered into satisfactory repayment arrangements, and/or is not currently in bankruptcy. The Department of Revenue's intent is to use these methods to encourage voluntary compliance. Taxpayers who are making a concerted effort to pay would be exempt. Taxpayers who contact the Department of Revenue and make satisfactory repayment arrangements would be released from denial/revocation. Revocations would be used only in instances where there had been a license denial and release because the taxpayer promised to pay, but failed to do so.

Other states:
1) Professional License Denial/Revocation Programs – Delaware, Hawaii, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Minnesota, Missouri, New Jersey, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, Vermont, and Wisconsin.
2) Vehicle Registration Denial: Massachusetts and Rhode Island
3) Drivers License Denial/Revocation: Massachusetts and Rhode Island

**Note:* Massachusetts and Rhode Island combined their Vehicle Registration and Drivers License programs.

Groups positively and negatively impacted: Positively impacted – Proponents of increased General Fund collections. Negatively impacted – Taxpayers who refuse to pay.

Revenue Score: The projected fiscal impact of this proposal, if enacted, is as follows:

1) **Professional License Denial/Revocation** – $250,000 General Fund increase in first full year of implementation, $2.9 million the second year.
2) **Drivers License Denial/Revocation** – $1.5 million in year two. A full year will need to be dedicated to system development. This will need to be a cooperative effort with county clerks, other state agencies including Kentucky State Police, and perhaps the Transportation Cabinet.
3) **Vehicle Registration Denial** – $1.5 million in year two. At least a full year needs to be dedicated to system development. This project needs to be a cooperative effort with county clerks and the Transportation Cabinet.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

PROPOSAL: Amend tobacco tax laws to provide clarifications and administrative improvements enabling the Department of Revenue to better enforce Kentucky tobacco tax laws

Note: This is a proposal from the Department of Revenue.

Background information: The proposed changes will include licensing requirements updates; other administrative reporting updates; and clarifications regarding sales of other tobacco products by out of state manufacturers/distributors into Kentucky. Also, clarification in regard to commercial cigarette making machines and market inequities caused by disparities in federal tax rates on "roll your own" tobacco, etc.

Other states: Surrounding states have various methods of taxing tobacco products. Several aspects of surrounding states' statutes have been used in developing legislation to close loopholes in Kentucky's statutes. Tennessee taxes little cigars as cigarettes. West Virginia is attempting to treat commercial cigarette making machines at retail locations as manufacturers.

Groups positively and negatively impacted: Positively impacted – Kentucky and resident cigarette and other tobacco products wholesalers. Negatively impacted – Out of state premium cigar interests and out of state cigarette and other tobacco products wholesalers.

Revenue Score: An increase to the General Fund of up to $3 million per year can occur

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

PROPOSAL: Apply statute of limitations evenly to both assessments and refund claims. Extend the number of days to protest an assessment to at least 60 days, preferably 90 days.

Background information: There is a two-year difference in statute of limitations for refunds to a taxpayer based on unconstitutional findings. This time difference was to reduce the likelihood of a catastrophic reduction in receipts as a result of refunds. This reasoning also applies to assessments made by the Department of Revenue as it is barred from collecting or assessing a resulting tax based upon the unconstitutional issue.

Other states: The statute of limitations for assessments and refunds in other states varies between 2 – 4 years.

Groups positively and negatively impacted: Positively impacted – Taxpayers would be positively impacted by the change by having more tax periods eligible for refunds. Negatively impacted – the General Fund and Road Fund.

Revenue Score: An unknown reduction to the General Fund and Road Fund will occur.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	N

PROPOSAL: Clarify the definition of "pollution control facilities" under tangible personal property tax statutes.

Note: This is a proposal from the Department of Revenue.

Background information: Adopting this proposal will simplify Kentucky's tax code by clarifying key terms that will clearly state that real property is subject to state and local property tax rates, which prevents pollution control facilities from claiming a lower tax rate. The Department of Revenue seeks to clarify that for a "pollution control facility," ONLY tangible personal
property is taxable at a state rate of 15¢/$100 of assessed value. It also is exempt from local taxation for ad valorem purposes. If this proposal is not enacted, there is a potential General Fund loss of $1,000,000.

Other states:

- Indiana: Certified pollution control facilities are exempt. Illinois Certified pollution control facilities (real property) are assessed at the fair cash value of their economic productivity to the owners.
- Missouri: Pollution control equipment assessed at 25% of fair cash value. Commercial real property assessed at 32% of fair cash value.
- Ohio: Facilities for the control of air, noise, and water pollution are exempt.
- Tennessee: Facilities valued at their "salvage value," commencing January 1 of the year following the date of application for certification.
- West Virginia: Facilities placed into operation after July 1973 are valued for property tax purposes at their "salvage value." This is defined as the price for which the facility would sell in place if voluntarily offered for sale by the owner.
- Virginia: Localities are required to exempt certified pollution control equipment along with facilities placed in service on or after July 1, 2006. Beginning January 1, 2011 all such equipment and facilities, excluding land, are exempt, regardless of the date placed in service.

Groups positively and negatively impacted: Positively impacted – Local taxing districts. Negatively impacted – Privately-owned contained solid waste landfills.

Revenue Score: If enacted, this proposal will prevent a loss to the General Fund of $1 million.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	N	+

PROPOSAL: Define the terms "broadcast" and "telephonic equipment" in the tangible personal property tax statutes.

Note: This is a proposal from the Department of Revenue.

Background information: Adopting this proposal will simplify Kentucky's tax code by clarifying key terms. There is not a current statutory definition of "broadcast" or "telephonic equipment", although there is one in case law. Potential fiscal impact of an adverse court decision is noteworthy, with a possible loss of $1,500,000 in state revenue, and $4,000,000 in local revenue.

Other states:

- Indiana: Locally assessed and taxed.
- Illinois: All personal property is exempt from property taxation.
- Missouri: Commercial personal property equipment assessed at 33.33% of fair cash value. Telecommunication companies are assessed centrally by the state tax commission. The state rate is 3 cents per $100.

- Ohio: Tax on telecommunication equipment was phased out beginning January 2010.
- Tennessee: Centrally assessed as a public utility property for local tax only. There is no state rate.
- West Virginia: Centrally assessed as a public utility property.
- Virginia: Centrally assessed for local tax only. There is no state rate.

Groups positively and negatively impacted: Positively impacted – Local taxing districts. Negatively impacted – Wireless (cellular) telephone companies & satellite communication service providers.

Revenue Score: If an adverse decision were to be issued by a court, there would be a loss of $1,500,000 to the state and $4,000,000 in local revenue.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	N	+

PROPOSAL: Eliminate the need for paper Form K-1E, Kentucky Employer's Return of Income Tax Withheld.

Background information: Currently, employers must file a paper Form K-1E with the Department of Revenue. It has been recommended that businesses should be allowed to file Form K-1E electronically, which would expedite the filing process for both taxpayers and Department of Revenue. The Department of Revenue is currently developing an electronic filing system for Form K-1E. This form should be available for electronic submission prior to December 31, 2013.

Other states: The surrounding states that impose individual income tax have payroll withholding reports that can be filed electronically.

Groups positively and negatively impacted: Positively impacted – Filing Form K-1E electronically would benefit both taxpayers and Department of Revenue. Negatively impacted – none.

Revenue Score: Unknown. There will be a small cost to add this form to the electronic filing platform.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	N	N	+

"A simple, easily understandable tax structure reduces administrative costs to the tax payer. Reducing the administrative cost provides businesses with additional capital to invest in activities that are therefore providing economic growth and jobs. From the state's perspective, a simplified tax structure provides enhanced compliance, yielding more revenues and lowering enforcement costs."

—TODD GRIFFEN, HIGHLAND HEIGHTS

PROPOSAL: Give multijurisdictional taxpayers a minimum of 180 days to report changes on a prior federal return at the state and local level.

Background information: Current state income tax law provides that a taxpayer shall submit a copy of the final determination of a federal income tax audit to the Department of Revenue within 30 days of the federal audit's conclusion. An identical requirement exists in Kentucky's local occupational tax statutes.

Other states: Most states do not have a time limit for taxpayers to submit copies of completed federal income tax audits. Their laws provide that the statute of limitations does not begin until an amended tax return is received. The time limit for taxpayers to submit copies of completed federal income tax audits to local jurisdictions in other states is unknown.

Groups positively and negatively impacted: Positively impacted – this proposal would benefit multijurisdictional taxpayers as they would have additional time to file amended Kentucky income tax and local occupational tax returns to reflect federal audit adjustments. Negatively impacted – the General Fund and local occupational tax receipts. Extending the date to submit a copy of the final determination of a federal audit may delay the collection of taxes.

Revenue Score: An unknown decrease to the General Fund and local occupational tax receipts will result if tax collections are delayed. Interest would accrue during the extended period for state taxes.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	–	N

PROPOSAL: Clarify installment payment agreement provisions.

Note: This is a proposal from the Department of Revenue.

Background information: The Department of Revenue proposes to amend the taxpayer bill of rights to clarify the exact parameters of an "installment agreement." This proposal also will establish the Department of Revenue as the final authority concerning terms of any installment payment agreement. Some taxpayers interpret current language as a means to slow down the collections process. Those taxpayers pay a smaller monthly amount rather than the amount stipulated by the department under a payment agreement. The current statute infers that taxpayers are entitled to a payment agreement and can set their own terms. Amending the statute will provide the Department of Revenue the ability to grant a payment agreement and to regulate minimum payments based on a taxpayer's ability to repay.

Other states: No border state has this provision in their statutes.

Groups positively and negatively impacted: Positively impacted – General Fund. Negatively impacted – Taxpayers who try to slow down the collections process by paying a smaller amount instead of the monthly amount stipulated by the department.

Revenue Score: Minimal

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
Not applicable	Not applicable	Not applicable	+	+

PROPOSAL: Repeal the Rural Electric Cooperative Corporation & Rural Telephone Cooperative Corporation Tax (one tax).

Note: This is a proposal from the Department of Revenue.

Background information: The Rural Electric Cooperative Corporation and Rural Telephone Cooperative Corporation Tax are "in lieu" of taxes which are $10 per year for each entity. It costs the Department of Revenue more to process the remittances than the revenues generated. Fiscal Year 2011 receipts totaled $310.

Other states: Other states have special levies for a variety of purposes but it is unknown if any states have an identical tax to this one.

Groups positively and negatively impacted: Positively impacted would be the Commonwealth due to elimination of inefficiencies and focus on more value-added activity. Negatively impacted – none.

Revenue Score: A net gain of $25,000 due to efficiency savings.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
Not applicable	Not applicable	Not applicable	Not applicable	+

PROPOSAL: Under the tangible personal property tax statutes, clarify that inventory-in-transit must be delivered to a permanent out-of-state destination in order to qualify for the under 6 month exclusion

Note: This is a proposal from the Department of Revenue.

Background information: This proposal intends to prevent the loss of state and local revenues by preventing claims that tangible personal property sent out of state temporarily is exempt from taxation. Taxpayers are claiming no personal property tax is owed for inventory that leaves the state within six months then returns at a later date. We believe this was not the intent of the legislation. By clarifying "destination" in the statute as "the place where an item of tangible property is sent permanently" this would prevent similar claims in the future that could result in the potential loss of ad valorem revenues for the state and local taxing districts. The consultants to the Commission listed eliminating the inventory tax as an option and that proposal, if adopted eliminates the need for this proposal.

Other states: Our border states exempt inventory in transit with Virginia's exemption applying only to property in a free trade zone.

Groups positively and negatively impacted: Positively impacted – Local taxing districts.
Negatively impacted – Companies that lease tangible personal property to out-of-state locations.

Revenue Score: There is no way to know what property currently classified as "Inventory" will be claimed to be "Inventory-in-Transit" in the future if no change is made. By making this change, future loss of revenue will be prevented.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	+	+

PROPOSAL: Update use tax notification and compliance requirements for remote vendors.

Note: This is a proposal from the Department of Revenue.

Background information: The Department of Revenue proposes to adopt use tax notification and compliance requirements for remote vendors similar to Oklahoma legislation passed in 2011. With tremendous increases in online and remote sales, a number of states are reviewing their requirements for use tax reporting by remote vendors. This proposal is the least onerous of concepts, which seeks to impose some reporting requirements on remote vendors without a collection obligation. Other states require remote vendors to collect the use tax either through affiliate nexus or click through mechanisms. Both types of statutes continue to be subject to unresolved legal challenges. The recent injunction, granted by the U.S. District Court regarding Colorado's reporting requirements, makes this tax area more uncertain. Any legislative proposal in this area is only meant to augment Kentucky's current Streamline Sales Tax efforts. It does not compete with federal legislation proposals granting remote collection authority.

Other states: At least thirty-seven states either have considered or passed legislation pertaining to remote tax collection. Judicial action is at various levels of determination throughout the country. Missouri, Tennessee and Virginia have proposed legislation in this area over the past

several years with none enacted. Oklahoma recently enacted legislation and is seeing some compliance and related revenue from online retailers. Those retailers are complying with posting requirements notifying Oklahoma customers of their use tax liabilities.

Groups positively and negatively impacted: Positively impacted – Kentucky Retail Federation, Kentucky merchants and Kentucky consumers who receive more timely notice of potential use tax liability. Negatively impacted – Direct Marketers Association.

Revenue Score: The fiscal estimate of this proposal is still under review but sales and use tax receipts could increase by nearly $5 million annually.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

PROPOSAL: Return to a balanced interest rate on taxes owed to and by the state.

Background information: A 2008 law change amended the tax interest rate from being equal for assessments and refunds to being increased by two percent for assessments and reduced by two percent for refunds. For example, the 2012 tax interest rate was established at four percent. Due to the 2008 law change, the rate for assessments is six percent and the rate for refunds is two percent.

"To ensure fairness, Kentucky should return to a balanced interest rate on taxes owed to and by the Commonwealth."

—BILL MEYER, KY SOCIETY OF CPAS

Other states: 11 states other than Kentucky have different interest rates for assessments and refunds.

Groups positively and negatively impacted: Positively impacted – taxpayers that receive assessments or are due a refund. Negatively impacted – the General Fund and Road Fund.

Revenue Score: An approximate revenue loss per year of $8 million.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	–	–	+

PROPOSAL: Add clarifying language in KRS 139.480(11) regarding farm machinery that specifies combine header trailers are exempt from sales tax.

Note: This is a proposal from the Department of Revenue.

Background information: Clarifying language for the farm machinery exemption to specifically include combine header trailers will ensure that all implement dealers and farmers alike receive the same treatment. The Department has provided recent administrative rulings to indicate this type machinery is exempt; however, history on this topic indicates some confusion and need for statutory clarification.

Other states: All border states offer some type of farm machinery exemption from sales tax. The exemption language for Indiana, Tennessee and Missouri appear to exclude header trailers from their exemption provisions.

Groups positively and negatively impacted: The explicit change to the farm machinery exemption will make the treatment of combine header trailers transparent to all parties.

Revenue Score: Revenue neutral.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	N	N	N	N

PROPOSAL: Repeal the school tax rate exclusion from sales tax calculation on "residential telecommunications service" found in KRS 139.470(9).

Note: This is a proposal from the Department of Revenue.

Background information: This provision excluding application of sales tax on the portion of a residential phone bill that includes a charge for the utility gross receipts license tax (school tax) was enacted in 1979. At the same time, the general residential utilities exemption went into effect. The school tax is a gross receipts tax up to a maximum rate of 3% imposed upon the provision of utility services within school districts that have elected to levy the tax. The tax is imposed upon the business providing the utility services. If the business passes the tax on to the customer as a line item, this portion of the receipt collections is still part of gross receipts subject to the 6% sales tax per the definition of gross receipts in KRS 139.010(12)(a)2. Without this exemption language in KRS 139.470(9), the school tax portion of a residential phone bill would be subject to the 6% sales tax. Please note that all telecommunications services other than pay phone services are subject to the 6% Kentucky sales tax (KRS 139.200).

Effective January 1, 2011, the definition of sales price was amended in the Streamlined Sales and Use Tax Agreement (SSUTA) to clarify what types of taxes a state may exclude from sales price. This change was made to increase uniformity and simplicity at the request of the retail community and telecommunications industry. The amendment to the administrative definition of "sales price" and accompanying Rule 327.9 specify that states may exclude from sales price those taxes on a retail sale that are 1) separately stated on the invoice, bill of sale or similar document given to the purchaser, 2) imposed on the seller and 3) allowed but not required to be passed on to the customer. These requirements do not allow Kentucky to continue exempting the

school tax only on residential phone bills. Kentucky has the option of expanding the exemption to apply to all billings for communications services which includes the school tax, but the SSUTA also requires that states be consistent across all similar taxes. Therefore, effecting this broader change would require the current sales price/gross receipts definition in KRS 139.010(12) to be amended to exclude not only the school tax but also state/local transient room taxes, local restaurant tourism taxes, alcoholic beverage taxes along with any other local or federal taxes that may get passed on to customers as a line item charge on a retail transaction. The options available to remain in compliance with the Streamlined Sales and Use Tax Agreement are a minor exemption rollback or a significant exemption expansion with a major fiscal impact.

Other states: The partial sales tax exemption for school tax on residential phone bills is unique to Kentucky. Of the 24 SSUTA states, there are 14 that apply sales tax to other state, local and federal taxes through their definition of sales price (KY, IN, OH and TN included). Six states exclude these taxes from the definition of sales price and four states have yet to resolve the issue in their jurisdictions.

Groups positively and negatively impacted: Positively impacted – rolling back the narrow exemption for the school tax on a residential phone bill is supported by the telecommunications industry. Several industry representatives acknowledge their systems cannot effectively track this partial exemption on a residential bill. Negatively impacted – residential landlines are declining in use and consumers are unlikely to notice minor changes to their monthly phone bill upon repeal.

Revenue Score: If the repeal is enacted, the General Fund will increase by an amount less than $500,000. If we fail to enact this proposal then our being found out of compliance with the Streamline Sales & Use Tax Agreement will ultimately result in a large decrease to the General Fund via the loss of significant voluntary compliance revenues received under this critical program.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	N	+	+	+

PROPOSAL: Review the disparity in the tax code and law between documented and undocumented boats.

Background information: In order to eliminate the disparity between the state property tax rate for documented" boats (1.5¢/$100 of assessment) and registered boats (45¢/$100) of assessment, all boats must be taxed at the same state rate. Prior to 1999 all owners paid the full state tax rate of .45¢ per $100.00 of assessed value of their boat. In 1998, HB 588 effective 1/1/99, lowered the property tax rate to 1.5¢ per $100 of assessed value on certain federally documented vessels. These vessels are not in the business of transporting people or property for hire or other

commercial purposes. HB 588 also allowed local governments and taxing districts to exempt these same vessels from local property tax.

Other states:
Indiana: Indiana levies and collects a Boat Excise Tax. The amount of the excise tax depends on the age and value of the watercraft when it was new, according to the current boat class tax schedule. Motorboat and sailboat excise taxes range from $2 to $500, depending on the boat's class. The excise tax is reduced annually but the reduction will never exceed 50 percent of the boat's original tax value. The excise tax for stored motorboats and sailboats is $12 annually.
Ohio: Property tax on watercraft is assessed and taxed at the local level. Different rates apply for each county.
Illinois: Illinois does not tax personal property.
Tennessee: Property tax on boats is assessed and collected at the local level. Different rates apply for each county.
Virginia: Boats are assessed and taxed at the local level.
Missouri: Boats are assessed and taxed at the local level.

Groups positively and negatively impacted: The impact depends on the option selected. There will be winners and losers among affected taxpayers. The General Fund will be negatively impacted if the state rate is reduced or eliminated. If a local option to exempt all boats is passed, local governments could be negatively impacted if the option is exercised.

Revenue Score: Unknown because several options exist that could increase or decrease state property tax revenues.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	Not applicable	Not applicable	Not applicable	+

Appendices

A. Estimated Fiscal Impact of Commission Recommendations

B. Members of the Blue Ribbon Commission on Tax Reform

C. Executive Order

D. Press Release

E. *Taxation Boot Camp* by Greg Harkenrider, Office of the State Budget Director

F. *Prior Tax Reform Initiatives* by Greg Harkenrider, Office of the State Budget Director

G. *Tax Reform Options* by Greg Harkenrider, Office of the State Budget Director

H. *Economic Geography Issues and implications for fiscal policies in Kentucky* by Paul Coomes, , Ph.D., Professor of Economics, University of Louisville College of Business

I. *Gross Tax Receipts: an overview* by Robert L. Salyer, Instructor of Accountancy and Director of the Master of Accountancy Program, Northern Kentucky University

J. Tax Reform Public Meeting Speakers

K. List of individuals who submitted ideas

L. Report to Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants

M. Presentation of the Kentucky Society of CPAs

N. Presentation of the Department of Revenue

O. Presentation of the Office of the State Budget Director

P. Submission from Kentucky Organizations

   1. Letter from KY Press Association, KY Broadcasters Association, The Lexington Chapter of the American Advertising Federation, The Louisville Chapter of the American Advertising Federation, Lexington Herald Leader, Dawson Springs Progress
   2. Letters from Corydone Stone and Asphalt, Sellersburg Stone, Hanson Aggregates, Mulzer Crushed Stone, Inc., Indiana Mineral Aggregates Association
   3. Letter from Cabinet for Economic Development
   4. Letter from Kentucky Petroleum Marketers Association
   5. Report from ITEP
   6. Letter from Kentucky Council on Postsecondary Education
   7. Letter from Kentucky Thoroughbred Owners and Breeders, Inc.
   8. Letter from Ernst and Young
      a. *Total state and local business taxes: State-by-state estimates for fiscal year 2011*
      b. *Competitiveness of state and local business taxes on new investment: Ranking states by tax burden on new investment*

9. Fact Sheet from Greater Louisville Inc.
10. Letter from Kentucky Youth Advocates
11. Letter and Fact Sheet from North American Stainless
12. Letter from AARP
13. Letter from CMRS Board
14. Letter Wyatt, Tarrant and Combs, LLP
15. Letter Kentucky Public Retirees, Inc.
16. Letter Kentuckians for the Commonwealth
17. Report from Conserve KY
18. Letter from Vulcan Materials

Q. List of Proposals Rejected by the Commission

Estimated Fiscal Impact of Commission Recommendations

	Full Implementation Annual Impact in millions
Individual Income Tax	
• Reduce the individual income tax rate structure	-$219.00
• Enact an Earned Income Tax Credit (EITC) at 15 percent of the federal EITC	-$115.00
• Limit itemized deductions to a $17,500 cap	$350.00
• Amend the pension income exclusion from $41,110 to $30,000, and phase out the exclusion for total income over $30,000	$485.00
• Change the reference to the Federal Code from December 31, 2006 to December 31, 2012	-$25.60
• Implement a tax deduction for 529 savings plan contributions	-$0.42
Subtotal	**$474.98**
Corporate Taxes	
• Lower the top corporate tax rate from 6.0 percent to 5.8 percent	-$9.00
• Change the current three-factor apportionment rule to implement single factor apportionment based solely on sales	-$110.00
• Change the existing cost-of-performance based formula for apportioning sales to incorporate a destination sourcing for services	-$10.00
• Amend the small-business standard from $3.0 million to $1.0 million and maintain the dollar-for-dollar phase-out for gross receipts or gross profits to $2.0 million	$13.00
• Establish an angel investor tax credit program for certain investments in small businesses	-$3.00
• Expand the state's R&D Tax Credit to human capital; cap the amount available; and require that it is approved through some governing body, such as KEDFA	-$4.00
• Fully decouple from the deduction for U.S. production activities (QPAI)	$4.00
• Add back management fees in the calculation of the corporate income tax base	$15.00
Subtotal	**-$104.00**
Sales and Excise Taxes	
• Apply sales tax and transient room taxes to entire hotel accommodation price	$4.50
• Broaden the sales tax to selected services*	106.00*
• Exempt mail charges for direct mail from sales tax	-$3.00
• Impose a gross receipts tax of 1 percent on both residential and business utilities and dedicate additional revenues to the SEEK funding formula	$101.50
• Increase collection of out-of-state and Internet sales. Support federal legislation allowing states to require remote firms to collect sales tax	Unknown
• Increase the tax rate on cigarettes to $1.00**	$100.00**

• Increase the tax rate on other tobacco products commensurate to the cigarette tax**	$10.00**
• Repeal the distilled spirits case sales tax and Restore Cigarette Rolling Papers Tax	$0.80
• Exempt the sales and use tax on certain equine products to support the signature equine industry	-$14.00
• Apply sales tax to pre-written computer software made available for access without a download	Unknown
Subtotal	**$305.80**
Property Taxes	
• Create an income tax credit for the bourbon industry to offset the property tax on stored barrels of bourbon, without reducing local property taxes to school districts or local communities	-$12.60
• Exempt inventory from state property tax (merchant's inventory, manufactured finished goods, and goods stored in warehouse)	-$6.00
• Freeze the state property tax rate at 12 cents per $100 of value	-$8.00
• Clarify the identification of public service companies for taxation	Unknown
• Require reporting of the rental space for documented watercraft/private airplanes	Unknown
• Require reporting of the rental space for documented watercraft/private airplanes	-$5.00
• Provide for a review every five years of all tax incentives and expenditures	Not applicable
Subtotal	**-$31.60**
Severance Taxes	
• Eliminate the export credit under the minerals severance tax	$2.00
• Clarify the definition of "gross value" under severance tax	Prevents loss of $3.20
Subtotal	**$2.00**
Other Taxes/Issues	
• Impose the Pari-mutuel tax on advance deposit wagers made on live races conducted at Kentucky race tracks	$6.00
• Provide for a review every five years of all tax incentives and expenditures.	Not applicable
Subtotal	**$6.00**
Simplicity, Compliance and Tax Administration	
• Allow non-renewal of professional licenses, driver's licenses and vehicle registration if taxpayers have exhausted all appeals and still refuse to pay state taxes to improve collections	$5.90
• Amend tobacco tax laws to provide clarifications and administrative improvements enabling the Department of Revenue to better enforce Kentucky tobacco tax laws	$3.00

• Apply statute of limitations evenly to both assessments and refund claims. Extend the number of days to protest an assessment to at least 60 days, preferably 90 days	Potential large decrease in revenues
• Clarify the definition of "pollution control facilities" under tangible personal property tax statutes	Prevents loss of $1.00
• Define the terms "broadcast" and "telephonic equipment" in the tangible personal property tax statutes	Prevents loss of $1.50
• Eliminate the need for paper Form K-1E, Kentucky Employer's Return of Income Tax Withheld	Unknown
• Give multijurisdictional taxpayers a minimum of 180 days to report changes on a prior federal return at the state and local level	Unknown
• Clarify installment payment agreement provisions	Minimal
• Repeal the Rural Electric Cooperative Corporation & Rural Telephone Cooperative Corporation Tax (one tax)	$0.02
• Under the tangible personal property tax statutes, clarify that inventory-in-transit must be delivered to a permanent out-of-state destination in order to qualify for the under 6 month exclusion	Unknown
• Update use tax notification and compliance requirements for remote vendors	$5.00
• Return to a balanced interest rate on taxes owed to and by the state	(-8.00)
• Add clarifying language in KRS 139.480(11) regarding farm machinery that specifies combine header trailers are exempt from sales tax	$0.00
• Repeal the school tax rate exclusion from sales tax calculation on "residential telecommunications service" found in KRS 139.470(9)	Unknown
• Review the disparity in the tax code and law between documented and undocumented boats	Unknown
Subtotal	**$5.92**
Total General Fund Impact	**$659.10**
<u>Road Fund</u>	
• Stabilize fuels tax revenues to support highway funding by raising the floor of the average wholesale price for fuels taxes	$0.00
• Reduce dealer's compensation on motor fuels tax from 2.25% to 1%	$21.00
• Implement a trade-in credit for new car purchases that would equalize treatment for used vehicles and new vehicles	-$34.00
Total Road Fund Impact	**-$13.00**
<u>Local Taxes</u>	
• Amend Kentucky Constitution to permit local option sales taxes	($10 million) state impact
• Eliminate recall provisions on local rate setting for real property	No state revenue impact

Notes:

*Commission did not recommend specific services. Fiscal score represents the recommended services included in HB 262 of the 2008 Session.

** Does not include one-time inventory tax revenues.

MEMBERS OF THE BLUE RIBBON COMMISSION ON TAX REFORM

Roszalyn M. Akins
Roszalyn Akins, of Lexington, has served as an educator in the Fayette County Public School System for 27 years and is now dean of students at Leestown Middle School. She serves as the director of family life ministries and of the women's ministry at the First Baptist Church of Bracktown. Ms. Akins serves as President Council member for the Consolidated District Association of Baptist Churches. In 2006, Ms. Akins initiated an academy for black males, "Future BMW" (Black Males Working). She received a bachelor's degree from Transylvania University and a Master of Arts in education and history at Georgetown College.

Jason Bailey
Jason Bailey, of Berea, is director of the Kentucky Center for Economic Policy (KCEP) and research and policy director of the Mountain Association for Community Economic Development. KCEP is a nonpartisan research institute, which conducts analysis of the state budget and tax system as well as policy issues facing low- and moderate-income Kentuckians. Mr. Bailey serves on the Kentucky Commission on Small Business Advocacy and is a member of the National Advisory Board of the Rural Policy Research Institute. He has a master's degree in public administration with a specialization in public finance from New York University and a bachelor's degree from Carson-Newman College.

James H. Booth
James H. "Jim" Booth, of Inez, developed Booth Energy, producer of 7.5 million tons of coal per year that is delivered to utilities such as Georgia Power, Detroit Edison and American Electric Power. Mr. Booth serves on the boards of the University of Pikeville, Morehead State University, Inez Deposit Bank, Honey Branch Economic Development Authority, Coal Operators Associates, and the Kentucky Chamber of Commerce Executive Committee. Mr. Booth holds a bachelor's degree in business administration from Morehead State University.

Ulysses S. Bridgeman, Jr.
Ulysses S. "Junior" Bridgeman, of Louisville, is CEO of Bridgeman Foods Inc. He is also owner and president of Manna Inc. and oversees the administration and operation of 160 Wendy's restaurants in five states and 103 Chili's restaurants in seven states. He currently serves on the board of directors of Fifth Third Bank and is capital campaign co-chair for the African-American Heritage Foundation. Mr. Bridgeman graduated from the University of Louisville with a degree in psychology.

Rocky Comito
Rocky Comito of Shepherdsville, Kentucky is the former president of United Auto Workers Local 862 in Louisville, Kentucky. He previously served as an employee of Ford Motor Company for 34 years. Mr. Comito served on the board of the Metro United Way Labor Committee and was an Advisory Board Member of the Kentucky Labor/Management Conference. Mr. Comito earned a bachelors degree in business administration from the University of Louisville and a Masters degree in Industrial Technology from Eastern Kentucky University.

Luther Deaton
Luther Deaton Jr., of Nicholasville, is chairman, president and CEO of Central Bank and Trust Co. and Central Bancshares Inc., of Lexington. Mr. Deaton is a member of the American Bankers Association Government Relations Council. He also is past president of the Kentucky Bankers Association and past chairman of Commerce Lexington Inc. Mr. Deaton is a graduate of the Graduate School of Banking of the South at Louisiana State University and the National Commercial Lending School at the University of Oklahoma, Norman.

Marion C. Forcht
Marion C. Forcht, of Corbin, is controlling co-owner of Forcht Group of Kentucky, Forcht Bank, N.A., and president of Forcht Insurance Agency Inc. Mrs. Forcht also serves on the boards of Kentucky National Insurance Co., Kentucky Mutual Insurance Co., Kentucky Home Life Insurance Co. and Forcht Broadcasting Inc. She is also corporate secretary of Kentucky Mutual Insurance and Kentucky Home Life Insurance companies. Mrs. Forcht is a graduate of the University of Louisville and holds an honorary Doctor of Laws degree from the University of the Cumberlands.

Rick Jordan
Rick Jordan, of Walton, worked for 40 years in various positions in the manufacturing field at Tappan Appliance Co. and the Magic Chef Co. He served as vice president of Maytag Corp. He also served as former president of American Sign & Marketing and later vice president and general manager over LSI Graphic Solutions Plus. Mr. Jordan is the founding chair of the Gateway Community & Technical College board of directors. He is a past board member of the Northern Kentucky Chamber of Commerce. Mr. Jordan attended Franklin and Ohio State universities before serving a term in the U.S. Armed Forces.

Pat Mulloy
Pat Mulloy, of Louisville, is chairman and CEO of Elmcroft Senior Living, a national provider of senior housing services operating 103 communities in 19 states. Prior to joining Elmcroft Senior Living, Mr. Mulloy served as president and CEO of Louisville-based Atria Inc. Mr. Mulloy served as secretary of the Finance Cabinet from 1992-1994. He currently serves as the chairman of the board of trustees for Bellarmine University and is chairman of the Board of Advisors at Vanderbilt School of Law. He received his law degree from Vanderbilt University.

Sheila A. Schuster, Ph.D.
Dr. Sheila A. Schuster, of Louisville, is executive director of the Advocacy Action Network, an umbrella organization that includes the Kentucky Mental Health Coalition, Kentuckians for Health Care Reform, the United 874K Disabilities Coalition and the Kentucky Medicaid Consortium. Dr. Schuster has served on the boards of directors for a number of mental health, healthcare advocacy and civic organizations in the Louisville area and statewide. Dr. Schuster is a licensed clinical psychologist with graduate degrees from Purdue University and the University of Louisville.

Stu Silberman
Stu Silberman, of Lexington, is executive director of the Prichard Committee for Academic Excellence. Prior to joining the Prichard Committee, Mr. Silberman was superintendent of Fayette County Public Schools. His tenure in Fayette County was marked by a commitment to transparency and openness with the public, fiscal responsibility and a community effort called 2020 Vision to redesign education in Fayette County. He has 37 years of experience as an educator. He holds a bachelor's and master's degrees from the University of Tennessee at Chattanooga, and has an honorary doctorate from Kentucky Wesleyan University.

Dr. Lee T. Todd, Jr.
Dr. Lee T. Todd, Jr., of Lexington, is a former University of Kentucky president and a professor of engineering. He founded two high-technology companies based on his university research. Projectron Inc. developed and manufactured projection cathode-ray tubes for the flight simulation industry. DataBeam Corp. designed and developed software and systems for the teleconferencing market. Dr. Todd has been very active in national efforts to improve math and science education in American schools and to enhance America's economy based on university innovations. He received his undergraduate degree in electrical engineering from the University of Kentucky and his Ph.D. in electrical engineering from the Massachusetts Institute of Technology.

Leslie Weigel
Leslie Weigel, of Bowling Green, is a former banking executive at SunTrust Banks and is a former consultant to Head Start programs throughout the southeastern United States. Prior to retiring at SunTrust Banks, she served as the senior vice president of change management and investment governance in the office of the chief information officer in Atlanta, Ga. Mrs. Weigel is the current vice chair of the Service One Credit Union Board in Bowling Green. She received her bachelor's degree in political science and Master of Science in childhood development from the University of Delaware. She also obtained a Master of Business Administration from Vanderbilt University's Owen School of Management.

John A. Williams
John Williams, of Paducah, is founder and chairman of Computer Services Inc. (CSI). CSI is a software-as-a-service vendor to more than 5,000 community banks and other financial services organizations, providing a range of products from core processing to Internet- based services. He served as chairman of the Federal Reserve Bank of St. Louis, Louisville Branch; is a founder and former president of the Association of Financial Technology; and served in various offices in chamber of commerce organizations at the local and regional levels. He has served on numerous government and civic boards with an emphasis on public education and was instrumental in the creation of the Carson Performing Arts Center in Paducah.

Joe Wright
Joseph Wright, of Harned, is a former state senator and was majority floor leader of the Senate. He was also chairman of the Senate Agriculture and Small Business Committee. Mr. Wright served as a member of the Marine Corps Reserves. Mr. Wright is also the former chairman of the Breckinridge County School Board and president of the Burley Tobacco Growers Cooperative. He is a full-time farmer and co-owner of Wright Implement Co. Mr. Wright has a bachelor's degree in agricultural business from the University of Kentucky.

Cathy Zion
Cathy Zion, of Louisville, is the president and publisher of Zion LLC, which manages Today's Woman magazine, Today's Transitions magazine and Today's Family magazine. She is a former banking executive who served as vice president of operations at Fifth Third Bank of Kentucky. She currently serves on the BB&T Louisville Regional Advisory Board of Directors, is chair of Kentucky's Commission on Small Business Advocacy and serves on the Louisville SCORE Advisory Board. Ms. Zion graduated from Murray State University with a bachelor's degree in business and journalism and a master's degree in communications.

STEVEN L. BESHEAR
GOVERNOR

EXECUTIVE ORDER

2012 - 103
February 9, 2012

Secretary of State
Frankfort
Kentucky

GOVERNOR'S BLUE RIBBON COMMISSION ON TAX REFORM

WHEREAS, the Commonwealth has endured an historically significant recession while maintaining the retention and creation of new jobs as a top priority and recognizes the necessity of having a state taxing system that is consistent with that priority; and

WHEREAS, the state's tax code is in need of comprehensive review to determine and evaluate the capacity of the current revenue structure to provide the funding required for essential governmental services for the benefit of Kentucky businesses and its citizens during the balance of this decade and beyond; and

WHEREAS, there has been legitimate debate concerning the state's current tax code and its impact upon public policy and economic stakeholders, such that the time has come to forge a consensus of opinion regarding the state's tax policy through renewed in-depth study, discussion, argument and vigorous debate from members of both the public and private sectors; and

WHEREAS, there is a need to critically examine the potential for developing and enacting legislation concerning a more administratively efficient and less burdensome tax system, which will not only promote economic competitiveness, but also grow with the economy to provide revenues necessary to support the needs of the citizens, and be supportive of education, families and children, which constitute the fundamental priorities, values and hopes for all Kentuckians and Kentucky's future:

NOW, THEREFORE, I, Steven L. Beshear, Governor of the Commonwealth of Kentucky, pursuant to the authority vested in me by KRS 12.029, do hereby Order and Direct the following:

I. The Governor's Blue Ribbon Commission on Tax Reform (hereinafter "Commission") is hereby created and established. The Commission shall report directly to the Governor. The Commission shall have authority to hire a

STEVEN L. BESHEAR
GOVERNOR

EXECUTIVE ORDER

2012 - 103
February 9, 2012

consultant to provide assistance in performing the duties and responsibilities assigned to it by this Order.

II. The mission of the Commission shall be as follows:

A. Conduct a comprehensive study and examination of the Commonwealth's tax structure and recommend changes to the tax code in order to meet the long term needs of the state and its citizens.

B. Study the burden of taxation on Kentucky taxpayers, both individuals and businesses, as compared to taxpayers in other states.

C. Review recent changes and proposed modifications in the tax structures in other selected states.

D. Thoroughly examine and address tax policy considerations concerning the issues of adequacy, efficiency, fairness and equity, as well as economic competitiveness to determine whether the state's tax code currently operates in furtherance of these stated objectives.

E. Recommend changes to our tax system in order to:

1. fairly distribute the tax burden while keeping tax rates competitive;
2. create a favorable business environment for existing firms and entrepreneurs and help to attract and retain firms and industries that will spur growth for the Commonwealth;
3. provide sufficient elasticity so as to perform in accordance with changes in the economy;
4. produce revenue sufficient to adequately meet the needs of the state's highest priorities – including but not limited to education, jobs and protecting our most vulnerable citizens; and

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Secretary of State
Frankfort
Kentucky

5. ensure efficiency in the collection and administration of taxes, such that our system is cost-effective for the state and straightforward for taxpayers.

III. The Commission shall hold public meetings to receive input from the public and interested parties and shall receive testimony from experts in public finance, taxation and other stakeholders.

IV. The Commission shall complete its work and deliver its recommendations on issues, policies and programs affecting the Commonwealth's tax structure by no later than November 15, 2012.

V. The Commission shall be attached to the Office of the Governor for administrative and staff purposes. The Governor's Office and all state agencies are hereby directed to take all actions necessary to provide assistance as needed to the Commission so as to effectuate the provisions of this Order.

VI. The Commission shall be chaired by Lieutenant Governor, Jerry E. Abramson. Members of the Commission shall meet at the call of the chair. Members of the Commission shall not be compensated but may be reimbursed for actual expenses, if any, incurred while performing the duties of the Commission.

VII. I hereby appoint the following to serve as members of the Commission:

Roszalyn M. Akins
3389 Malone Drive
Lexington, Kentucky 40513

Jason M. Bailey
506 Center Street
Berea, Kentucky 40403

James H. Booth
Post office Box 1387
Inez, Kentucky 41224

Ulysses L. Bridgeman, Jr.
1604 Cherokee Road
Louisville, Kentucky 40205

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Secretary of State

Frankfort
Kentucky

Rocky Comito
2511 Idylewild Drive
Shepherdsville, Kentucky 40165

Luther Deaton, Jr.
8099 Harrodsburg Road
Nicholasville, Kentucky 40356

Marion C. Forcht
500 Scenic View Drive
Corbin, Kentucky 40701

R. Richard "Rick" Jordan, Jr.
11339 Sheffield Lane
Walton, Kentucky 41094

Pat Mulloy
2015 Camargo Road
Louisville, Kentucky 40207

Shelia A. Schuster, Ph.D.
120 Sears Avenue, Suite 212
Louisville, Kentucky 40207

Stu Silberman
909 Village Green Avenue
Lexington, Kentucky 40509

Lee T. Todd, Jr.,
2101 Hawksbury Way
Lexington, Kentucky 40515

Leslie A. Weigel
443 Ashmoor Avenue
Bowling Green, Kentucky 42101

Joe Wright
2200 HWY 259 S
Harned, Kentucky 40144

John A. Williams, Sr.
4015 Alameda Crescent
Paducah, Kentucky 42001

Cathy S. Zion
14908 Bircham Road
Louisville, Kentucky 40245

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GOVERNOR

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Secretary of State
Frankfort
Kentucky

Senator Bob Leeper
229 South Friendship Road
Paducah, Kentucky 42003
Non-Voting Ex Officio Member

Senator Paul Hornback
6102 Cropper Road
Shelbyville, Kentucky 40065
Non-Voting Ex Officio Member

Senator Gerald Neal
Suite 2150 Meidinger Twr
462 South 4th Street
Louisville, Kentucky 40202
Non-Voting Ex Officio Member

Representative Rick Rand
P.O. Box 273
Bedford, Kentucky 40006
Non-Voting Ex Officio Member

Representative Jim Wayne
1280 Royal Avenue
Louisville, Kentucky 40204
Non-Voting Ex Officio Member

Representative Bill Farmer
3361 Squire Oak Drive
Lexington, Kentucky 40515
Non-Voting Ex Officio Member

Please issue commissions to them.

STEVEN L. BESHEAR, GOVERNOR
COMMONWEALTH OF KENTUCKY

ALISON LUNDERGAN GRIMES
SECRETARY OF STATE

Commonwealth of Kentucky
Office of the Governor

FOR IMMEDIATE RELEASE

Contact: Kerri Richardson
502.564.2611
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Terry Sebastian
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502.229.6130

Gov. Beshear Announces Blue Ribbon Commission on Tax Reform; Calls for Fairer, More Competitive Tax Code

Raising revenue a key component of Commission's mission

LEXINGTON, Ky. (Jan. 5, 2012) – At the annual Kentucky Chamber Day dinner in Lexington, Governor Steve Beshear announced he will appoint a new commission on tax reform, led by Lt. Governor Jerry Abramson. The Blue Ribbon Commission on Tax Reform will study issues related to taxes in the state and will also hold public meetings on the subject. The Governor will also hire a consultant to study what tax efforts are working in nearby states.

In 2011, the national Tax Foundation ranked Kentucky's business tax climate as the 19th best in the nation, and in the growth rate of new jobs over the past year, Kentucky ranks 19th in the country. Despite those high national rankings, Gov. Beshear said the state has room to improve its tax code in order to encourage economic growth.

"Kentucky's system of taxation served us well during the recession," said Gov. Beshear. "But to prepare ourselves to compete in the future, we must, in a thoughtful and non-partisan way, re-align our system with the principles of fairness and with a 21st century economy."

In the State of the Commonwealth address Wednesday evening, the Governor said the process for tax reform would be inclusive and encourage all voices to have input. All options will be considered, and the tax changes will be framed to meet the state's future needs. In particular, the Governor expects the Commission to recommend ways to increase revenues in order to pay for and protect critical state services, such as education, public protection, and job creation.

Five elements for successful tax reform
The Governor set five goals for the commission:

- Fairness: The Commission will review the tax burden that different taxpayers shoulder, from Kentucky families to Kentucky businesses, from small businesses to big businesses, and within different industry sectors in the state. The tax system should treat people equitably.

- Competitiveness: Any changes to the tax system should ensure that Kentucky continues to attract jobs and investment to the state, while keeping and protecting the jobs and businesses we already have. The Commission will review how Kentucky compares to other states regarding business taxes, and identify ways to improve business tax competitiveness.

- Simplicity and Compliance: A tax system should be easy to understand and follow. The Commission will make recommendations to ensure compliance with Kentucky's tax system is simple for individuals and businesses and to ensure efficient administration by the state.

- Elasticity: The tax code should allow state revenue performance to mirror economic performance. While Kentucky's code has performed well during the recession, revenues may not keep pace once the economy recovers.

- Adequacy: The tax reform process should create a tax system that provides adequate revenue to fund critical state services. The tax structure should allow revenues to grow along with the economy.

The Commission will work over the next several months, with recommended legislation expected before the 2013 General Assembly. This allows time to build consensus as well as give more opportunity for the state's economic recovery to take hold.

Unemployment Insurance
Gov. Beshear applauded the state Chamber for their work on the Governor's Unemployment Insurance Task Force in 2009, which led to a recommendation from business and labor interests on how to keep the crucial unemployment insurance fund solvent.

Kentucky borrowed approximately $948 million from the federal government to support unemployment insurance, and thanks to the formula developed by the task force, has a plan for paying back the principal on that loan. Now, business and labor interests are again working with state leaders to figure out a mechanism to pay the interest on funds borrowed from the federal government.

"I'm confident that if we continue to sit down and negotiate in good faith, this problem will be solved," said Gov. Beshear.

###

Taxation Boot Camp

Presentation to the

Governor's Blue Ribbon Commission on Tax Reform

06 March 2012

Greg Harkenrider
Deputy Executive Director
Governor's Office for Economic Analysis
Office of State Budget Director
Osbd.ky.gov

Today's Orders

- ✓ **The terminology of taxation**
- ✓ **An objective rating system for the principles of optimal taxation**
  - ✓ Elasticity,
  - ✓ Fairness or Equity,
  - ✓ Competitiveness,
  - ✓ Simplicity and compliance; and
  - ✓ Adequacy;
- ✓ **An aggregate assessment of Kentucky's current tax code, as seen by the experts**
  - ✓ Is our current code desirable?
  - ✓ Areas tagged for improvements, as identified by prior reform efforts
- ✓ **A tax-by-tax summary of Kentucky's main sources of revenue**

Tax Terminology

- ✓ **Measures of Taxation Across Income Strata**
  - ✓ **Progressivity – Effective rate of taxation increases as levels of personal income increase**
    - ✓ **Example: Personal income tax with increasing rate brackets with higher levels of income**
  - ✓ **Proportional – Effective rate of taxation is constant across strata of personal income**
    - ✓ **A flat tax for all levels of income**
  - ✓ **Regressivity – Effective rate of taxation decreases as a percentage of personal income**
    - ✓ **A sales tax on tangible property, excise taxes**
    - ✓ **Kentucky somewhat protected by exempting food and RX drugs, which are inelastically demanded**

Economic Efficiency – The Holy Grail

- ✓ All taxes should have a minimal or neutral effect on the optimal behavior individuals and businesses.
- ✓ An optimal tax system minimizes distortions to efficient behavior.
- ✓ All of the desirable properties of a free and open economy assume that economic agents (individuals and businesses) make their decisions on the economic merits of production functions and utility functions, not tax policy.

Tax Reform – Elasticity

- ✓ In particular, the General Fund elasticity of personal income growth (in relation to unity)
- ✓ Does the budgeted revenue increase at a rate commensurate with the economy?
  - ✓ Desirable in order to fund necessary government services, and
  - ✓ Desirable to sock away a Rainy Day Fund in times when the economy contracts
- ✓ Which taxes are the most elastic?
  - ✓ Broadest base, lowest rates

Tax Fairness

- ✓ The individual income tax is the primary tax type that introduces progressivity into a state tax system and thus affects the perception of fairness in the distribution of the tax burden.
- ✓ Horizontal equity (taxpayers with equal ability to pay should bear the same tax burden) and vertical equity (taxpayers with greater ability should have tax burdens at least equal to those with less ability to pay) are necessary to achieve equity.
- ✓ Tax bases should be defined as broadly as possible to reduce horizontal and vertical inequities caused by excluding economic activity from the base. Uniform tax rates should be applied to all sources of income, categories of consumption, or types of property that are included in the tax bases
- ✓ State credits and exemptions should be used to shelter low-income taxpayers from high effective tax rates, improving vertical equity. Credits, such as the property tax circuit breaker (statutory provisions which limit revenue growth when compared to economic growth) can also be implemented to reduce horizontal inequities between taxpayers living in different jurisdictions.
- ✓ There should be a balanced use of income, consumption, and property taxes in the overall state and the local tax system. At the local level, a tax system structured to include several broad-based tax options provides jurisdictions the flexibility to adjust the tax mixture to accommodate variations in ability to pay.

Tax Fairness

- ✓ To reduce horizontal inequities among taxpayers in different jurisdictions, the state should ensure uniformity in the definition and measurement of local tax bases and should establish an acceptable range of statutory tax rates
- ✓ The interpretation of fairness is largely subjective. However, expanding the base and lowering the rates of Kentucky's taxes is a win-win solution, mitigating equity effects while removing distortions caused by unnecessarily high tax rates.
- ✓ Some of the strongest criticism of Kentucky's tax code concerns its failure to adjust to changing costs of living. Rate classes, low-income credit thresholds, and personal credits have largely remained at their original levels. Addressing inflation, which has robbed Kentucky's income tax of its progressivity, would enhance vertical equity.

Tax Reform – Economic Growth

- **Economic growth** -- States compete with one another in the attraction and retention of individuals and businesses. Tax policy should not be a deterrent to either goal.

- **Transparency** --The taxpaying community must understand the system of taxation and fully understand the need for and uses of tax revenues.

Tax Reform – Competitiveness

- ✓ To reduce the distorting effects of state and local taxes on specific groups of taxpayers or types of economic activity, a balanced package of broad-based taxes with moderate marginal tax rates is desirable. **Taxes with high rates and narrow bases should be avoided.**
- ✓ Kentucky has lower than average business tax burdens and slightly higher than average individual tax burdens. For businesses, the income taxes present the most significant tax burdens in comparison with other states. For households, individual income taxes are generally the source of the greatest burden relative to other states.
- ✓ Kentucky's business taxes are "competitive" when compared to neighboring states.

Tax Reform – Adequacy

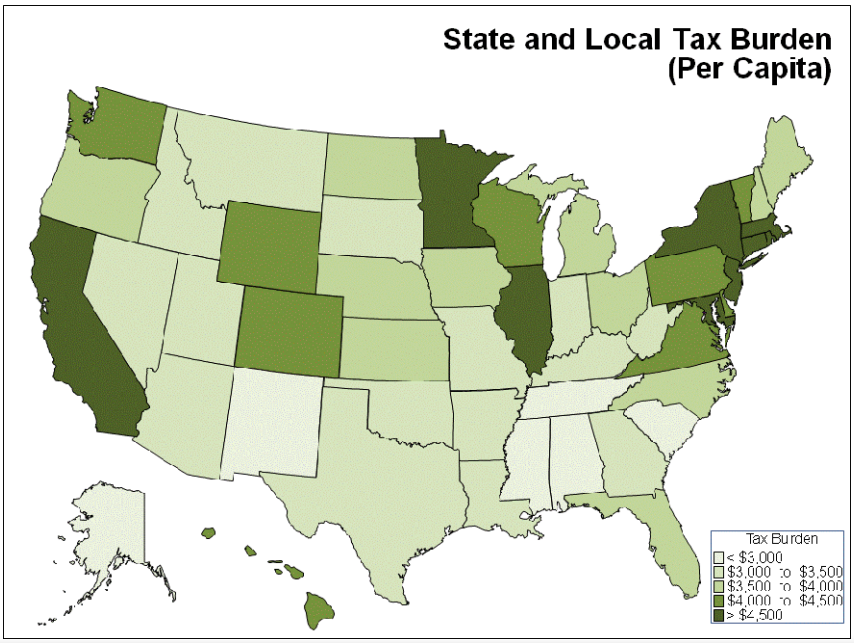
- ✓ A balanced use of income, consumption, property taxes and user fees should provide increased revenue stability over the economic cycle. The property tax and a broad-based sales tax that includes services, for example, get high marks in terms of cyclical stability.
- ✓ A balanced tax system would also contribute to sufficient growth in state and local taxes to match expenditure growth without frequent discretionary tax rate and base changes. This also contributes to reliability by providing taxpayers with greater certainty about their future tax liabilities as they make economic decisions.
- ✓ The corporate income tax represents a smaller percentage of state tax revenue and statewide personal income than the national average. Factors that affect the effective income tax rate, other than the income tax rate itself, include the determination of the taxable base, the apportionment formula used to determine the percentage of multi-state income attributable to the state, and the numerous economic development credits and other tax incentive measures meant to encourage investment in the state. Over the long-term, a number of economic, demographic, and political trends suggest that Kentucky's state and local system of revenue gathering might not be adequate.

Tax Reform – Adequacy

- ✓ Individuals are receiving a greater portion of their income from nontaxable sources. Consumers are purchasing an increasing amount of untaxed services and avoiding the sales tax through Internet or catalog purchases.
- ✓ Kentucky's population is aging at a faster rate than most states, and this will likely reduce some state and local tax receipts because elderly households tend to have lower consumer expenditures and to spend less on taxed items.
- ✓ Adequate revenue growth is achieved by adopting the proper balance of revenue instruments. The required balance will depend on specific characteristics of the tax structure. For example, income taxes grow faster relative to the economy with a more progressive income tax and sales taxes will grow more rapidly when broader taxation of services is adopted.

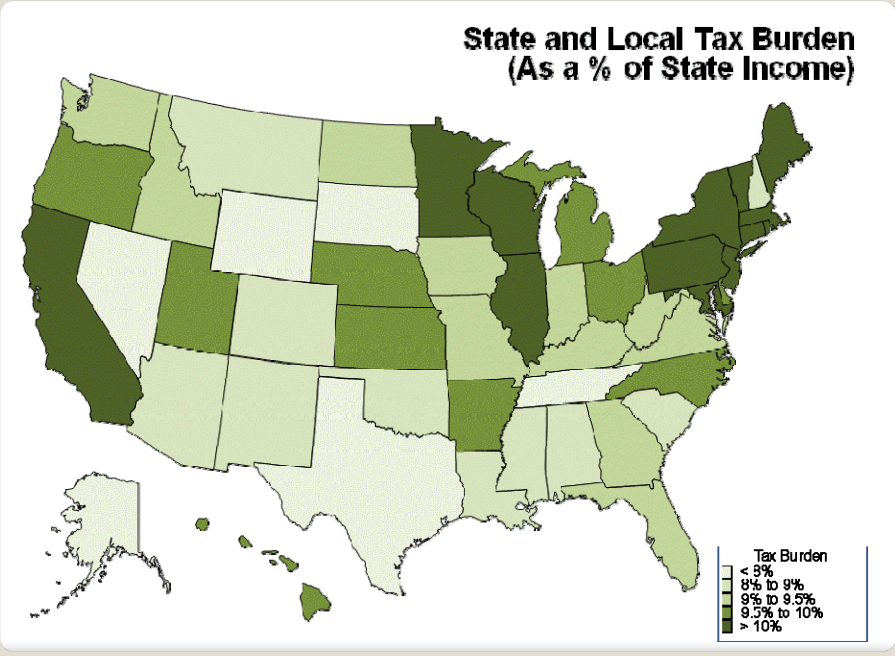
State and Local Tax Burden Per Capita

STATE	BURDEN	STATE	BURDEN	STATE	BURDEN
Alabama	$ 2,967	**Kentucky**	**$ 3,059**	N. Dakota	$ 3,892
Alaska	$ 2,973	Louisiana	$ 3,037	Ohio	$ 3,652
Arizona	$ 3,140	Maine	$ 3,832	Oklahoma	$ 3,259
Arkansas	$ 3,281	Maryland	$ 5,218	Oregon	$ 3,761
California	$ 4,910	Mass.	$ 5,316	Penn.	$ 4,190
Colorado	$ 4,011	Michigan	$ 3,565	R. Island	$ 4,647
Connecticut	$ 7,256	Minnesota	$ 4,651	S. Carolina	$ 2,742
Delaware	$ 4,091	Mississippi	$ 2,678	S. Dakota	$ 3,042
Florida	$ 3,897	Missouri	$ 3,425	Tennessee	$ 2,752
Georgia	$ 3,350	Montana	$ 3,216	Texas	$ 3,197
D.C.	$ 6,076	Nebraska	$ 3,960	Utah	$ 3,349
Hawaii	$ 4,399	Nevada	$ 3,311	Vermont	$ 4,181
Idaho	$ 3,276	N. Hampshire	$ 3,765	Virginia	$ 4,392
Illinois	$ 4,596	New Jersey	$ 6,751	Washington	$ 4,408
Indiana	$ 3,396	N. Mexico	$ 2,997	W. Virginia	$ 3,034
Iowa	$ 3,688	N. York	$ 6,157	Wisconsin	$ 4,427
Kansas	$ 3,911	N. Carolina	$ 3,583	Wyoming	$ 4,205



State and Local Tax Burden (% of S.P.I.)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	8.5%	**Kentucky**	9.3%	N. Dakota	9.5%
Alaska	6.3%	Louisiana	8.2%	Ohio	9.7%
Arizona	8.7%	Maine	10.1%	Oklahoma	8.7%
Arkansas	9.9%	Maryland	10.0%	Oregon	9.8%
California	10.6%	Mass.	10.0%	Penn.	10.1%
Colorado	8.6%	Michigan	9.7%	R. Island	10.7%
Connecticut	12.0%	Minnesota	10.3%	S. Carolina	8.1%
Delaware	9.6%	Mississippi	8.7%	S. Dakota	7.6%
Florida		Missouri	9.0%	Tennessee	7.6%
Georgia	9.2%	Montana	8.7%	Texas	7.9%
D.C.	9.1%	Nebraska	9.8%	Utah	9.7%
Hawaii	9.6%	Nevada	7.5%	Vermont	10.2%
Idaho	9.4%	N. Hampshire	8.0%	Virginia	9.1%
Illinois	10.0%	New Jersey	12.2%	Washington	9.3%
Indiana	9.5%	N. Mexico	8.4%	W. Virginia	9.4%
Iowa	9.5%	N. York	12.1%	Wisconsin	11.0%
Kansas	9.7%	N. Carolina	9.8%	Wyoming	7.8%



Distribution of State and Local Tax Collections by Tax (2009)

Taxes	Kentucky	All States as a Whole
Individual Income	31.3%	21.3%
General Sales	20.6%	22.9%
Property	20.6%	33.4%
Selected Sales	16.9%	11.2%
Corporate Income	3.6%	3.6%
Other	6.9%	7.7%
Total	100%	100%

Source: Staff analysis of data from U.S. Census Bureau's State and Local Government Finances.

Distribution of State Tax Collections by Tax (2009)

Taxes	Kentucky	All States as a Whole
Individual Income	34.0%	34.4%
General Sales	29.3%	32.0%
Property	5.3%	1.8%
Selected Sales	18.5%	16.2%
Corporate Income	4.0%	5.5%
Other	8.8%	10.2%
Total	100%	100%

Source: Staff analysis of data from U.S. Census Bureau's State and Local Government Finances.

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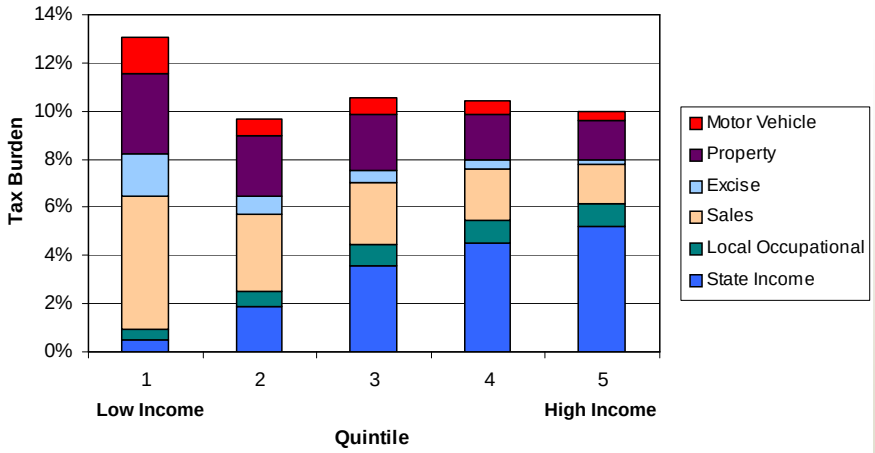
Distribution of Local Tax Collections by Tax (2009)

Taxes	Kentucky	All States as a Whole
Individual Income	24.8%	4.4%
General Sales	0%	11.2%
Property	56.8%	73.9%
Selected Sales	13.1%	4.8%
Corporate Income	2.8%	1.2%
Other	2.4%	4.4%
Total	100%	100%

Source: Staff analysis of data from U.S. Census Bureau's State and Local Government Finances

18

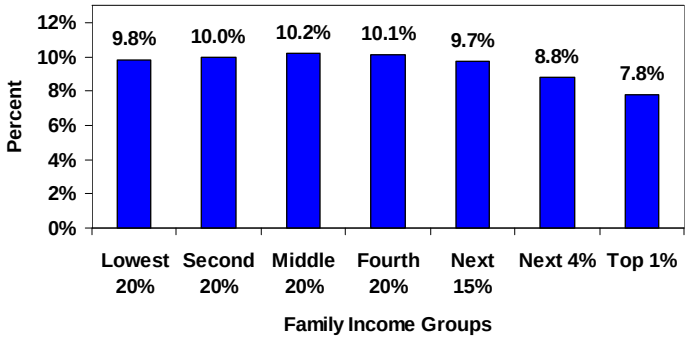
Kentucky's Tax Burden by Family Income Quintile



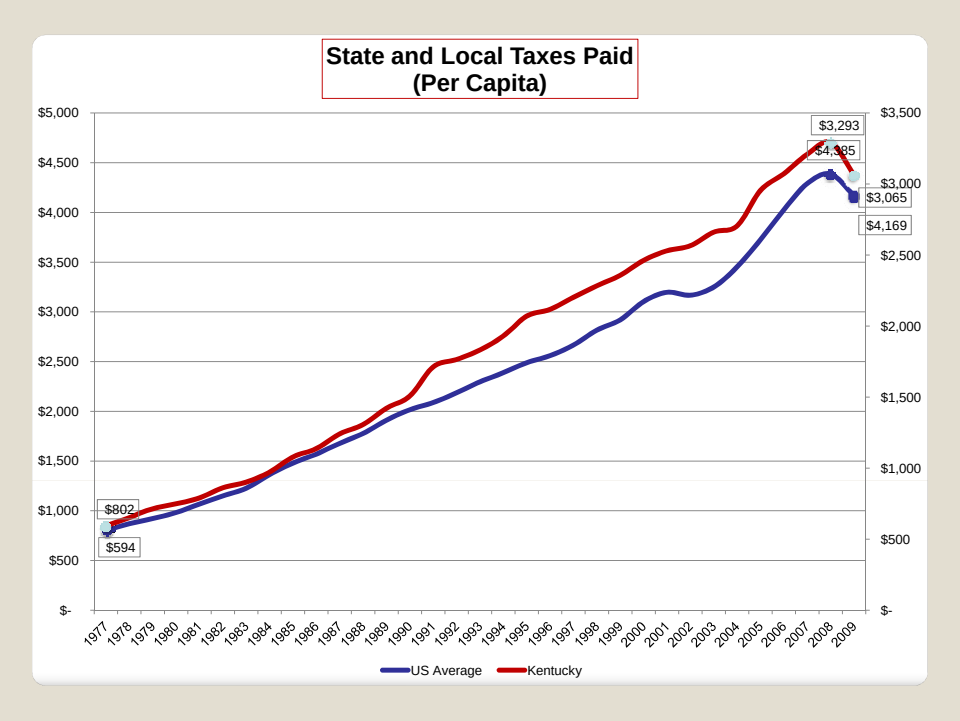
Source: LRC Staff Memo to IJC on Health and Welfare, September 28, 2001.

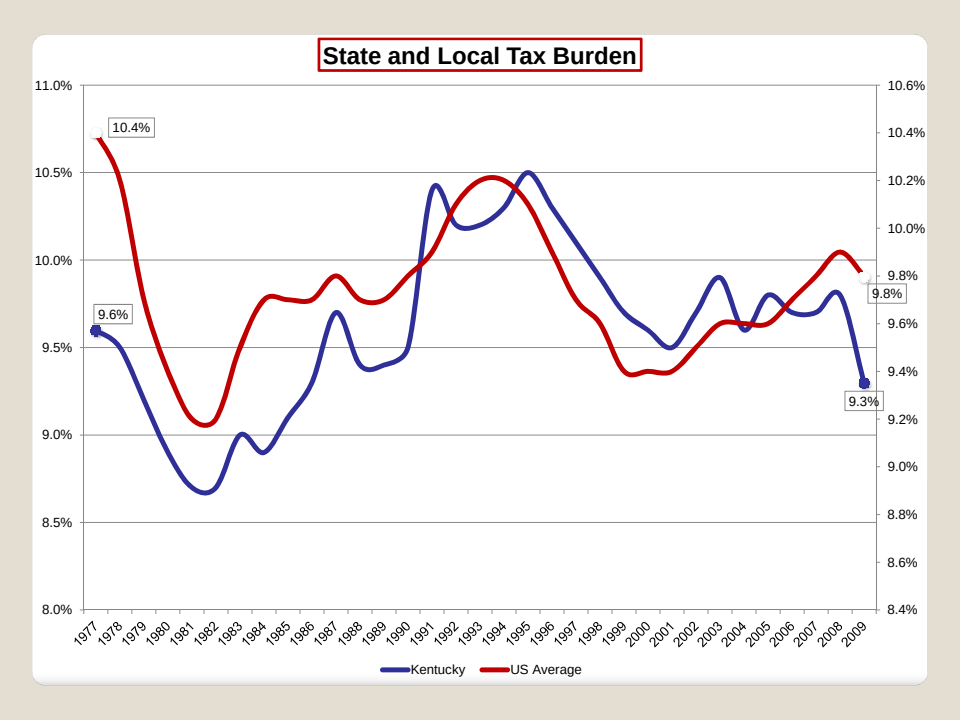
Institute on Taxation and Economic Policy

Kentucky State & Local Taxes in 2002
(Shares of Family Income for non-elderly Taxpayers)



Source: Institute on Taxation and Economic Policy. "Who Pays? A Distributional Analysis of the Tax Systems of All 50 States." 2nd Edition. January 2003.


State and Local Taxes Paid
(Per Capita)
$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$-
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$-
$802
$594
$3,293
$4,185
$3,065
$4,169
1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
US Average
Kentucky


State and Local Tax Burden
11.0%
10.5%
10.0%
9.5%
9.0%
8.5%
8.0%
10.6%
10.4%
10.2%
10.0%
9.8%
9.6%
9.4%
9.2%
9.0%
8.8%
8.6%
8.4%
10.4%
9.6%
9.8%
9.3%
1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Kentucky
US Average

Individual Income Tax

KRS 141.020 & Various IRC Sections

Tax Base: The individual income tax is levied on taxable income. Taxable income is computed by reducing gross income by trade or business expenses and the standard deduction ($2,210 for 2010) or at the option of the taxpayer by itemized deduction. Gross income is defined as gross income under the 2009 Internal Revenue Code with certain adjustments.

Base of Taxation is an offshoot of Federal Adjusted Gross Income

Individual Income Tax

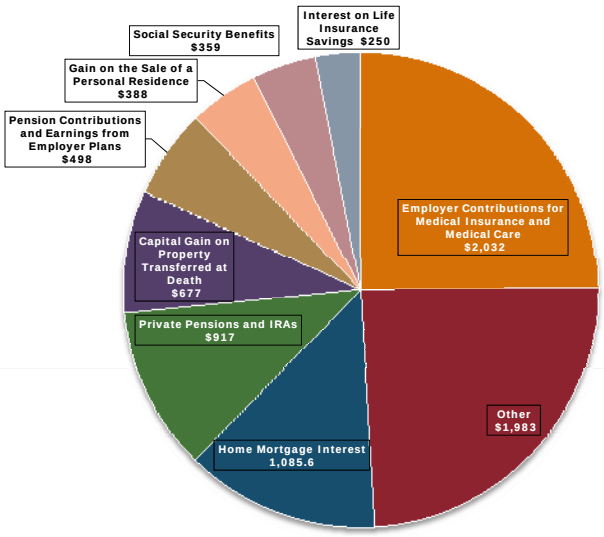
Rates and Collection

Tax Rate:	First	-	$3,000	2%
	$3,001	-	$4,000	3%
	$4,001	-	$5,000	4%
	$5,001	-	$8,000	5%
	$8,001	-	$75,000	5.8%
	Over		$75,000	6%

Total Receipts

Actual FY2011	$3.4 billion
Tax Expenditures for FY2012	$8.2 billion

Individual Income Tax Expenditures (Millions)

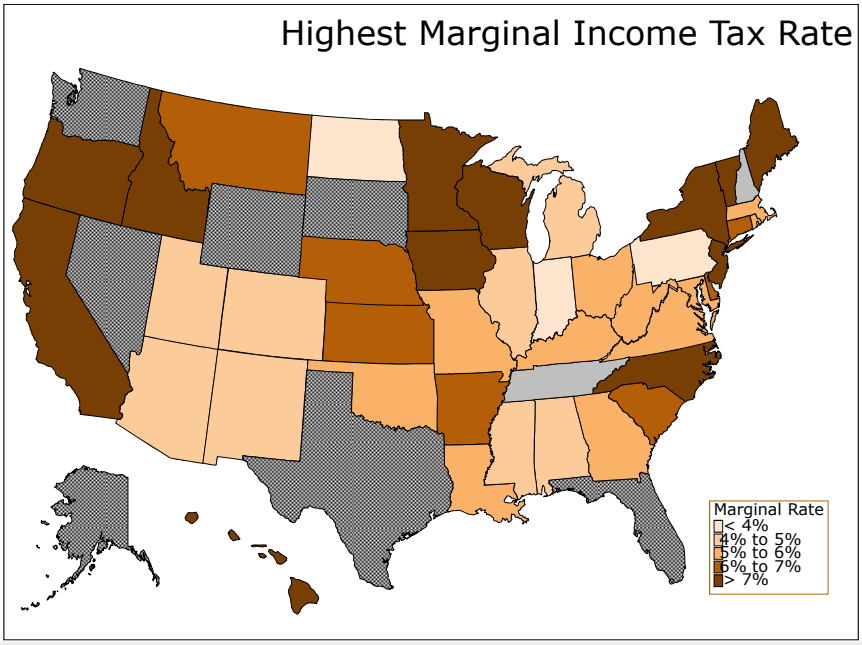


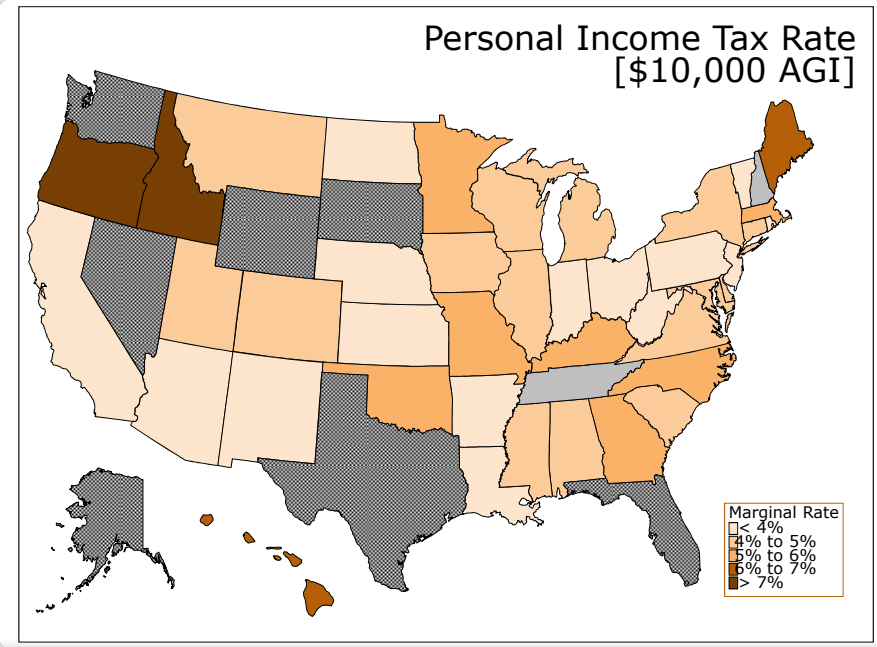
Personal Income Tax Rate ($10,000 AGI)

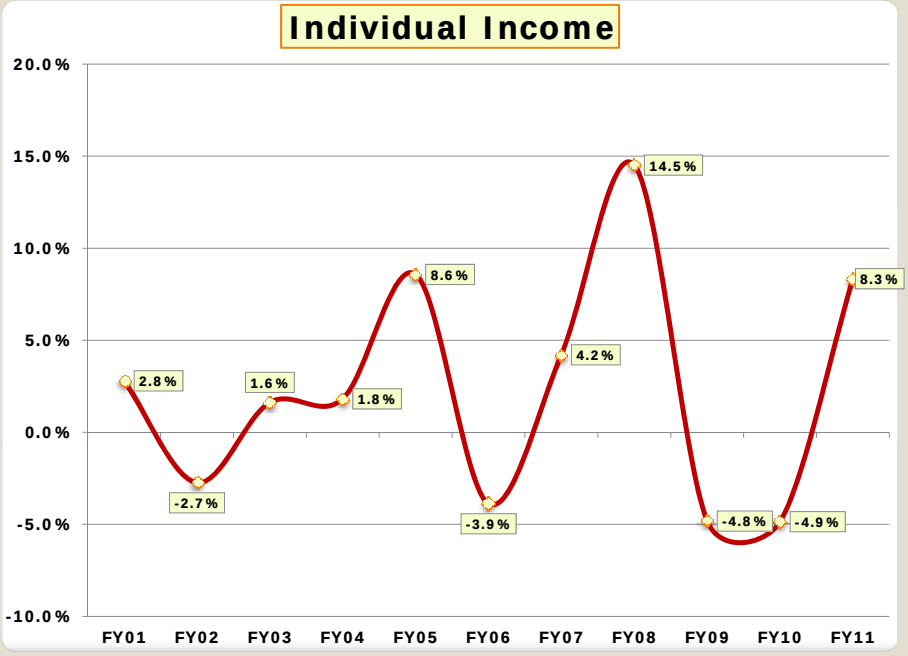
STATE	RATE	STATE	RATE	STATE	RATE
Alabama	5.00%	**Kentucky**	5.80%	N. Dakota	1.51%
Alaska	0.00%	Louisiana	2.00%	Ohio	1.17%
Arizona	2.88%	Maine	7.00%	Oklahoma	5.25%
Arkansas	3.50%	Maryland	4.75%	Oregon	9.00%
California	2.00%	Mass.	5.30%	Penn.	3.07%
Colorado	4.63%	Michigan	4.35%	R. Island	3.75%
Connecticut	5.00%	Minnesota	5.35%	S. Carolina	5.00%
Delaware	4.80%	Mississippi	5.00%	S. Dakota	0.00%
Florida	6.00%	Missouri	6.00%	Tennessee	6.00%
Georgia	0.00%	Montana	5.00%	Texas	0.00%
D.C.	6.00%	Nebraska	3.57%	Utah	5.00%
Hawaii	6.40%	Nevada	0.00%	Vermont	3.55%
Idaho	7.10%	N. Hampshire	5.00%	Virginia	5.00%
Illinois	5.00%	New Jersey	1.40%	Washington	0.00%
Indiana	3.40%	N. Mexico	3.20%	W. Virginia	4.00%
Iowa	4.50%	N. York	4.50%	Wisconsin	4.60%
Kansas	3.50%	N. Carolina	6.00%	Wyoming	0.00%

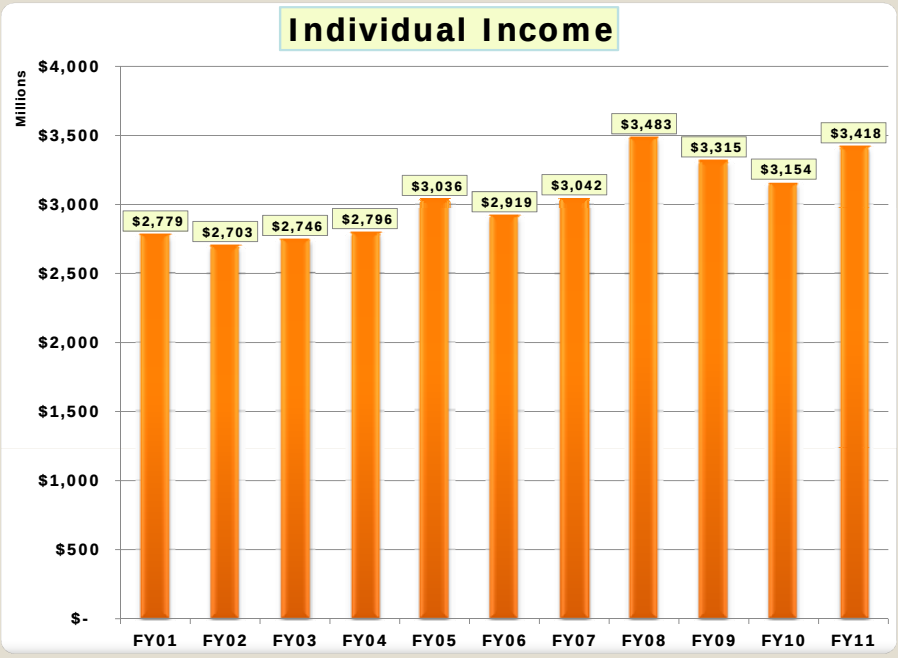
Personal Income Tax Rate ($100,000 AGI)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	5.00%	**Kentucky**	6.00%	N. Dakota	3.13%
Alaska	0.00%	Louisiana	6.00%	Ohio	4.70%
Arizona	4.54%	Maine	8.50%	Oklahoma	5.25%
Arkansas	7.00%	Maryland	4.75%	Oregon	9.00%
California	9.30%	Mass.	5.30%	Penn.	3.07%
Colorado	4.63%	Michigan	4.35%	R. Island	4.75%
Connecticut	6.00%	Minnesota	7.85%	S. Carolina	7.00%
Delaware	6.75%	Mississippi	5.00%	S. Dakota	0.00%
Florida	8.50%	Missouri	6.00%	Tennessee	6.00%
Georgia	0.00%	Montana	6.90%	Texas	0.00%
D.C.	6.00%	Nebraska	6.84%	Utah	5.00%
Hawaii	8.25%	Nevada	0.00%	Vermont	7.80%
Idaho	7.80%	N. Hampshire	5.00%	Virginia	5.75%
Illinois	5.00%	New Jersey	6.37%	Washington	0.00%
Indiana	3.40%	N. Mexico	4.90%	W. Virginia	6.00%
Iowa	8.98%	N. York	6.65%	Wisconsin	6.50%
Kansas	6.45%	N. Carolina	7.75%	Wyoming	0.00%




Personal Income Tax Rate
[$10,000 AGI]
Marginal Rate
< 4%
4% to 5%
5% to 6%
6% to 7%
> 7%


Individual Income
20.0%
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
2.8%
-2.7%
1.6%
1.8%
8.6%
-3.9%
4.2%
14.5%
-4.8%
-4.9%
8.3%
FY01
FY02
FY03
FY04
FY05
FY06
FY07
FY08
FY09
FY10
FY11



Sales Tax

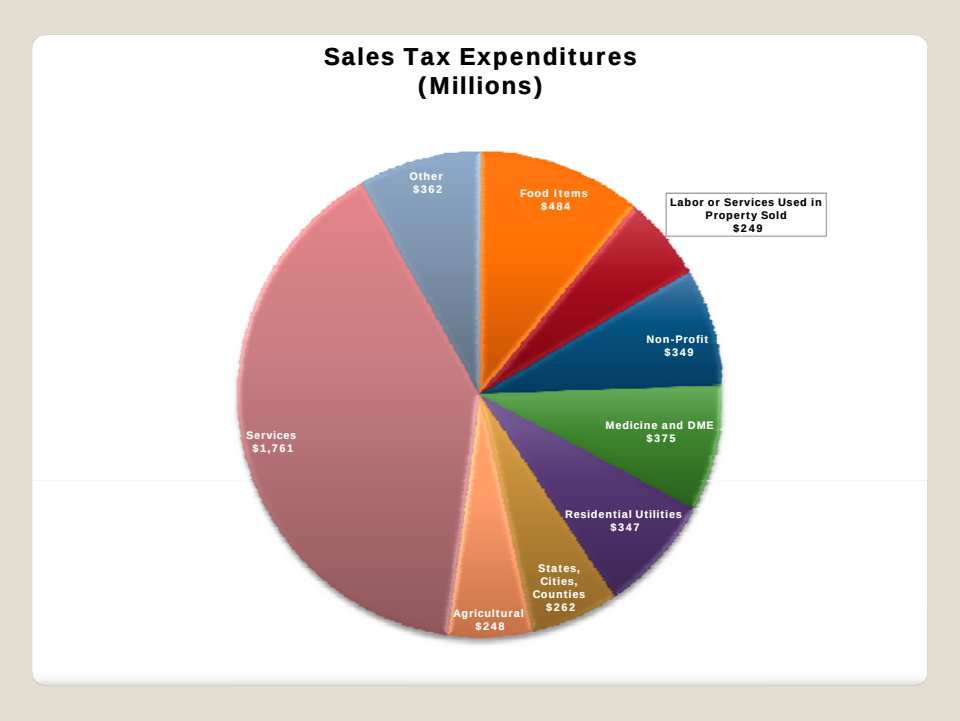
Imposition in KRS 139.200

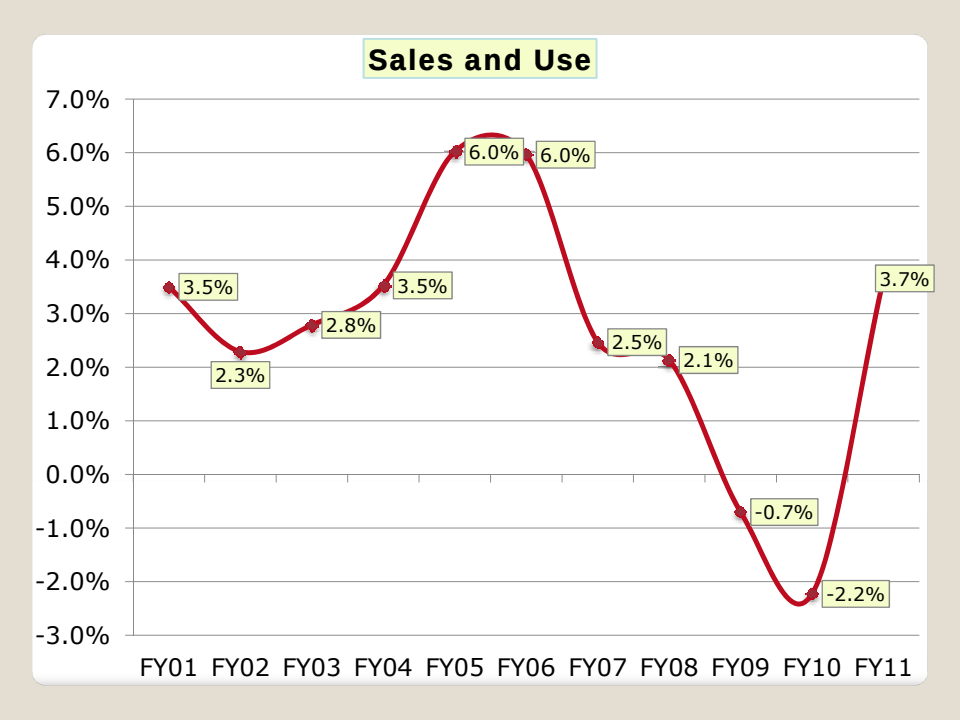
Tax Base: The tax base for the sales tax is gross receipts derived from both retail sales of tangible personal property and sales of certain services to the final consumer in Kentucky. The tax base for the use tax is the purchase price of tangible personal property purchased for storage, use, or other consumption in Kentucky.

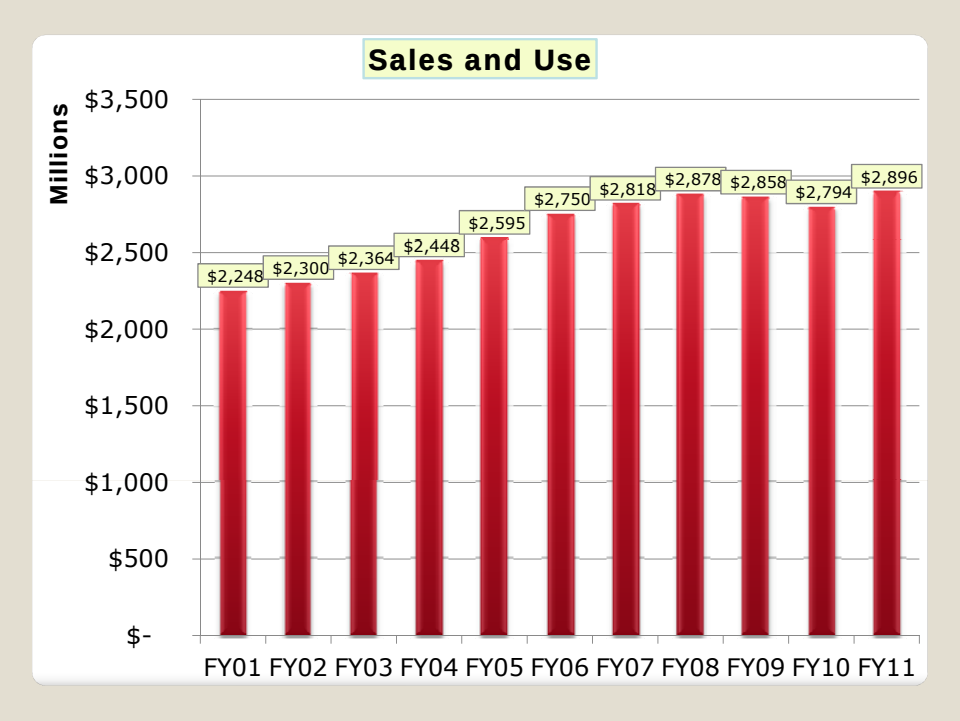
Tax Rate: Sales and use taxes are imposed at the rate of 6 percent of gross receipts or purchase price.

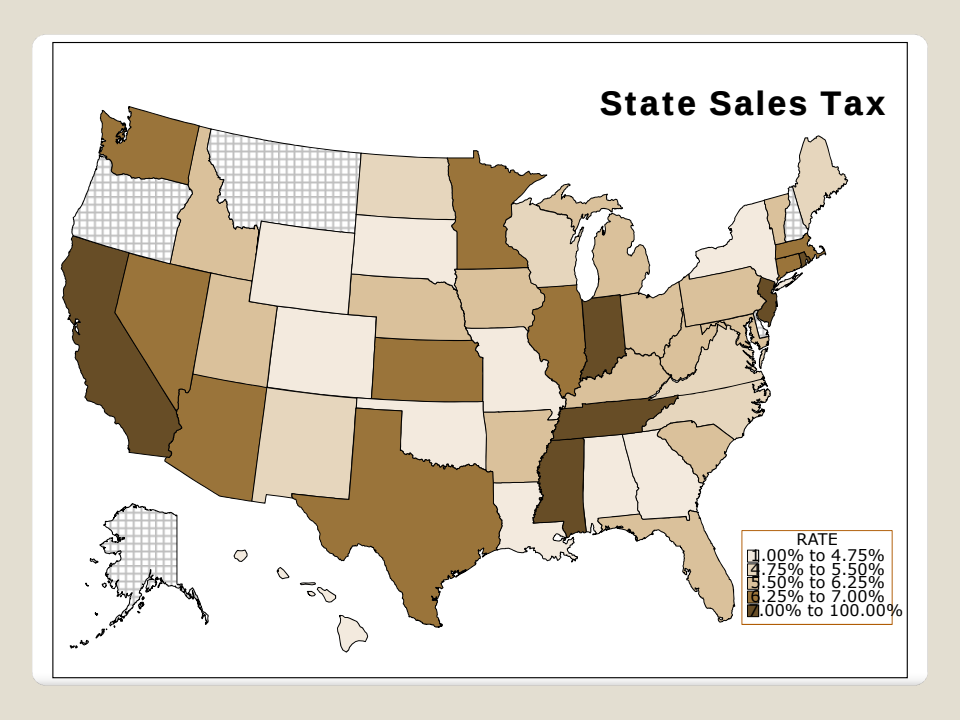
Tax Receipts:

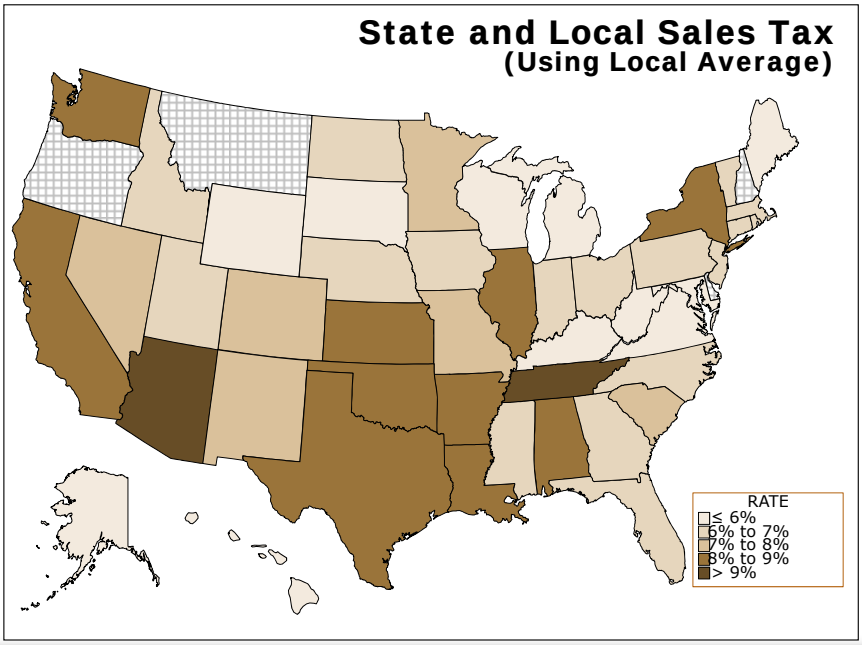
Actual FY2011	$2.896 billion
Tax Expenditures for FY12	$2.676 billion


Sales Tax Expenditures
(Millions)
Other
$362
Food Items
$484
Labor or Services Used in
Property Sold
$249
Non-Profit
$349
Medicine and DME
$375
Residential Utilities
$347
States,
Cities,
Counties
$262
Agricultural
$248
Services
$1,761


Sales and Use
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
-3.0%
3.5%
2.3%
2.8%
3.5%
6.0%
6.0%
2.5%
2.1%
-0.7%
-2.2%
3.7%
FY01
FY02
FY03
FY04
FY05
FY06
FY07
FY08
FY09
FY10
FY11


Sales and Use
Millions
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$-
$2,248
$2,300
$2,364
$2,448
$2,595
$2,750
$2,818
$2,878
$2,858
$2,794
$2,896
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11


State Sales Tax
RATE
1.00% to 4.75%
4.75% to 5.50%
5.50% to 6.25%
6.25% to 7.00%
7.00% to 100.00%



State Sales Tax Rate

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	4.00%	**Kentucky**	6.00%	N. Dakota	5.00%
Alaska	0.00%	Louisiana	4.00%	Ohio	5.50%
Arizona	6.60%	Maine	5.00%	Oklahoma	4.50%
Arkansas	6.00%	Maryland	6.00%	Oregon	0.00%
California	7.25%	Mass.	6.25%	Penn.	6.00%
Colorado	2.90%	Michigan	6.00%	R. Island	7.00%
Connecticut	6.35%	Minnesota	6.88%	S. Carolina	6.00%
Delaware	0.00%	Mississippi	7.00%	S. Dakota	4.00%
Florida	6.00%	Missouri	4.23%	Tennessee	7.00%
Georgia	6.00%	Montana	0.00%	Texas	6.25%
D.C.	4.00%	Nebraska	5.50%	Utah	5.95%
Hawaii	4.00%	Nevada	6.85%	Vermont	6.00%
Idaho	6.00%	N. Hampshire	0.00%	Virginia	5.00%
Illinois	6.25%	New Jersey	7.00%	Washington	6.50%
Indiana	7.00%	N. Mexico	5.13%	W. Virginia	6.00%
Iowa	6.00%	N. York	4.00%	Wisconsin	5.00%
Kansas	6.30%	N. Carolina	4.75%	Wyoming	4.00%

State and Local Sales Tax Rate (Local Average)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	8.33%	**Kentucky**	6.00%	N. Dakota	6.39%
Alaska	1.77%	Louisiana	8.85%	Ohio	6.75%
Arizona	9.12%	Maine	5.00%	Oklahoma	8.66%
Arkansas	8.58%	Maryland	6.00%	Oregon	0.00%
California	8.11%	Mass.	6.25%	Penn.	6.34%
Colorado	7.44%	Michigan	6.00%	R. Island	7.00%
Connecticut	6.35%	Minnesota	7.18%	S. Carolina	7.13%
Delaware	0.00%	Mississippi	7.00%	S. Dakota	5.39%
Florida	6.00%	Missouri	7.49%	Tennessee	9.45%
Georgia	6.62%	Montana	0.00%	Texas	8.14%
D.C.	6.84%	Nebraska	6.77%	Utah	6.68%
Hawaii	4.35%	Nevada	7.93%	Vermont	6.14%
Idaho	6.02%	N. Hampshire	0.00%	Virginia	5.00%
Illinois	8.20%	New Jersey	6.97%	Washington	8.80%
Indiana	7.00%	N. Mexico	7.25%	W. Virginia	6.00%
Iowa	6.81%	N. York	8.48%	Wisconsin	5.43%
Kansas	8.26%	N. Carolina	6.85%	Wyoming	5.34%

Coal Severance

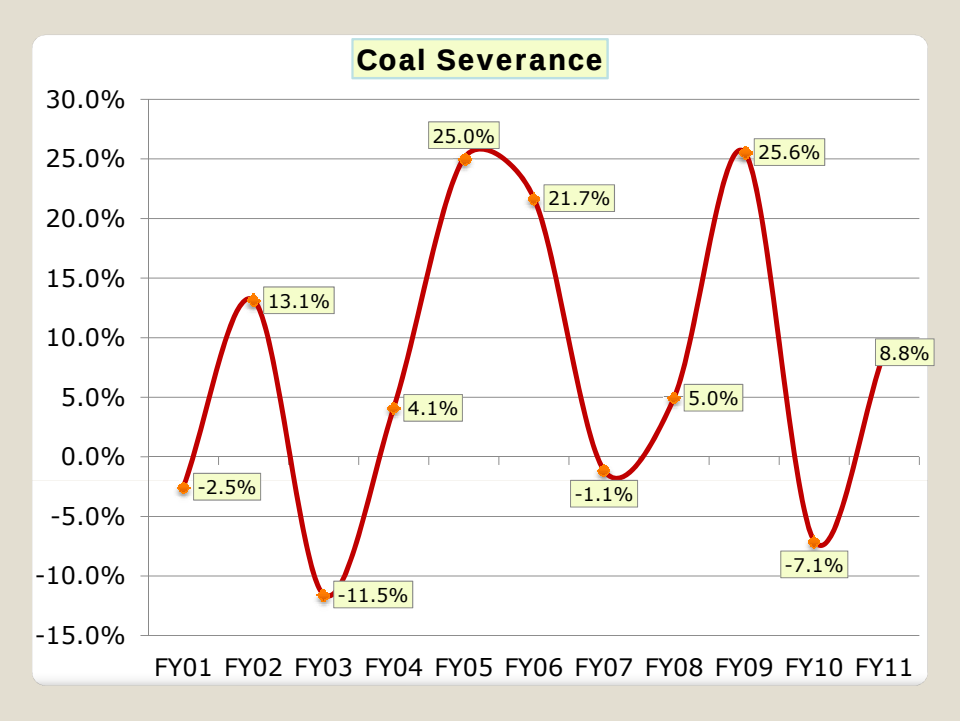
Imposition in KRS 143.020 et al.

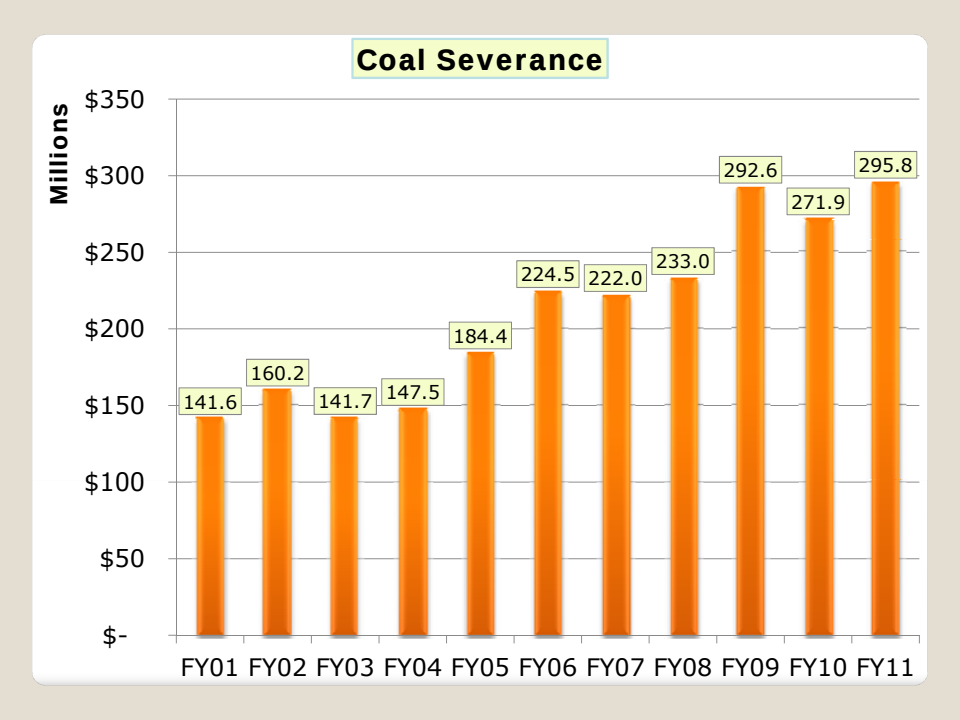
Tax Base: The tax is levied on the gross value of the coal. Gross value is the amount received or receivable for the coal, or market value if the coal is consumed and not sold, less transportation expense.

Tax Rate: 4.5 percent of gross value with a minimum tax of fifty cents per ton. The minimum tax does not apply in the case of taxpayers who only process coal. For coal used for burning solid waste the tax is limited to the lesser of 4 percent of the selling price or fifty cents per ton.

Total Receipts

Actual FY2011	**$295.8 million**
Tax Expenditures for FY2012	**$2.4 million**


Coal Severance
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-2.5%
13.1%
-11.5%
4.1%
25.0%
21.7%
-1.1%
5.0%
25.6%
-7.1%
8.8%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11


Coal Severance
Millions
$350
$300
$250
$200
$150
$100
$50
$-
141.6
160.2
141.7
147.5
184.4
224.5
222.0
233.0
292.6
271.9
295.8
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11

Corporate Income Tax
Imposition in KRS 141.040

Tax Base: The tax base for the corporation income tax is taxable net income. Taxable net income is essentially gross income minus allowable deductions, with apportionment and allocation provisions for multistate corporations.

Tax Rate:

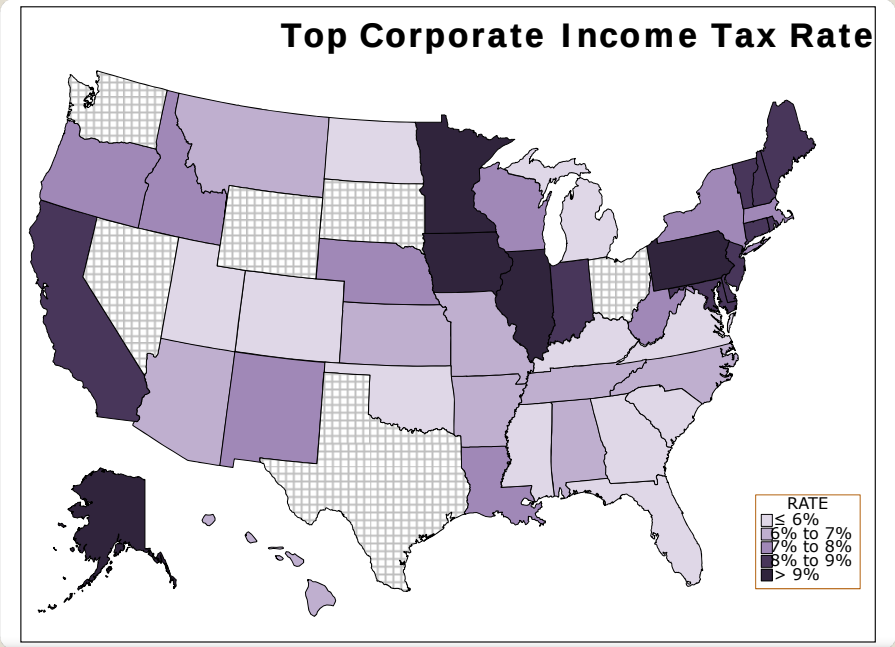
First $50,000	4.0%
$50,000 to $100,000	5.0%
Over - $100,000	6.0%

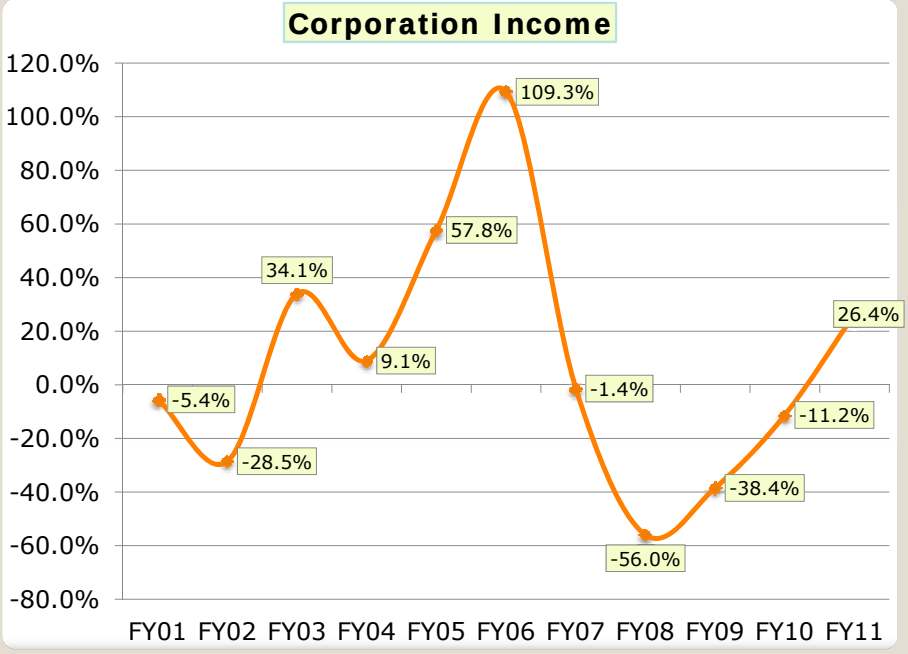
Total Receipts

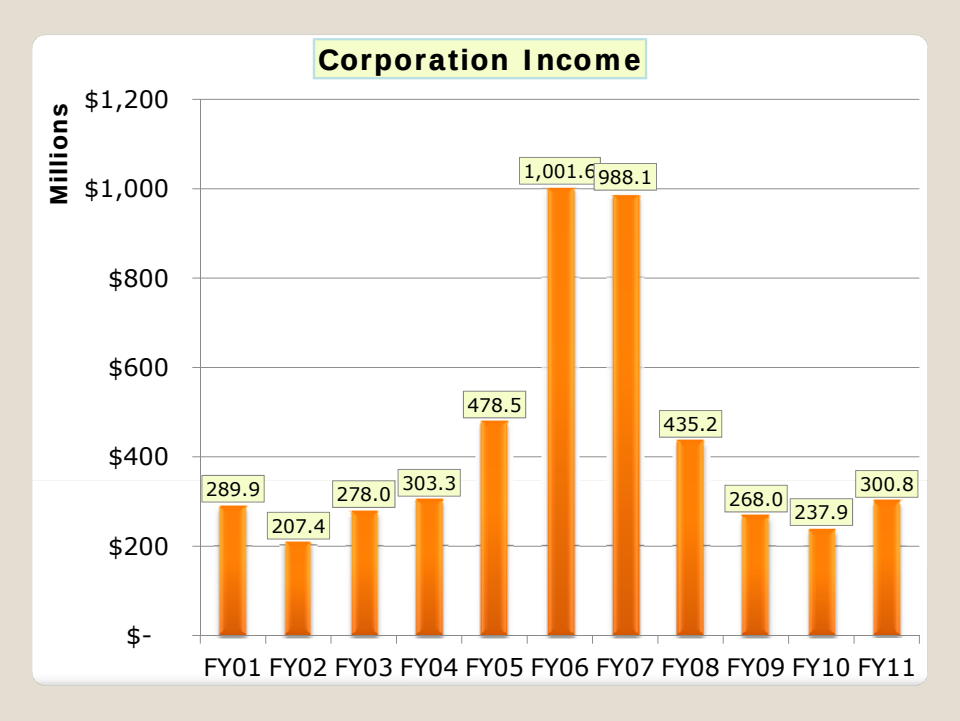
Actual FY2011	$300.8 million
Tax Expenditures for FY2012	$292.3 million

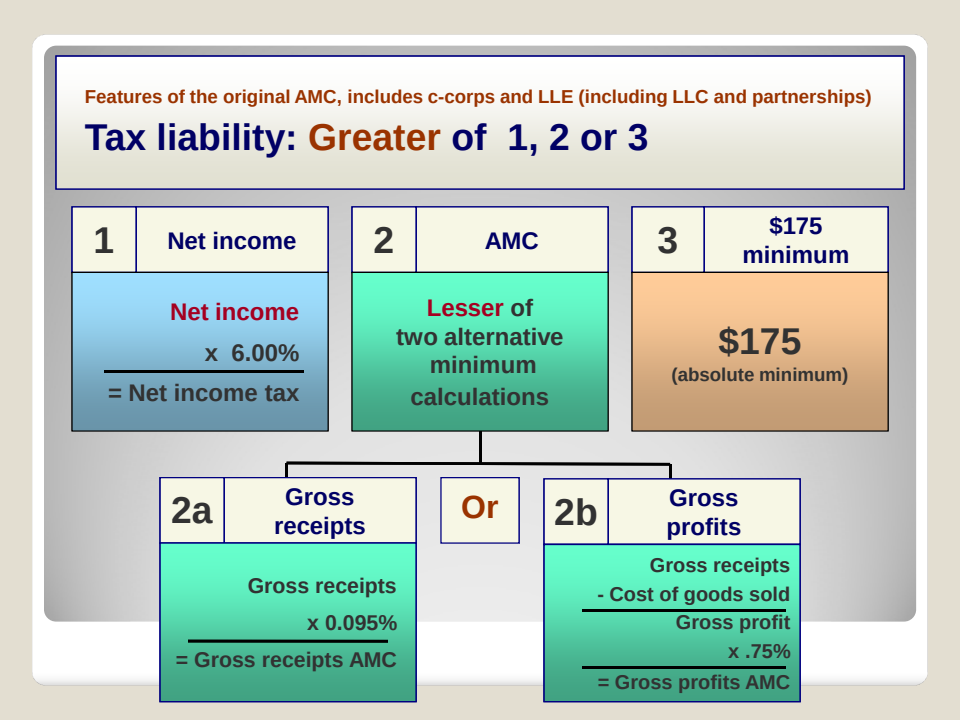
Top Corporate Income Tax Rate

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	6.50%	**Kentucky**	6.00%	N. Dakota	5.20%
Alaska	9.40%	Louisiana	8.00%	Ohio	0.00%
Arizona	6.97%	Maine	8.93%	Oklahoma	6.00%
Arkansas	6.50%	Maryland	8.25%	Oregon	7.60%
California	8.84%	Mass.	8.00%	Penn.	9.99%
Colorado	4.63%	Michigan	6.00%	R. Island	9.00%
Connecticut	9.00%	Minnesota	9.80%	S. Carolina	5.00%
Delaware	8.70%	Mississippi	5.00%	S. Dakota	0.00%
Florida	9.98%	Missouri	6.25%	Tennessee	6.50%
Georgia	5.50%	Montana	6.75%	Texas	0.00%
D.C.	6.00%	Nebraska	7.81%	Utah	5.00%
Hawaii	6.40%	Nevada	0.00%	Vermont	8.50%
Idaho	7.60%	N. Hampshire	8.50%	Virginia	6.00%
Illinois	9.50%	New Jersey	9.00%	Washington	0.00%
Indiana	8.50%	N. Mexico	7.60%	W. Virginia	7.75%
Iowa	12.00%	N. York	7.10%	Wisconsin	7.90%
Kansas	7.00%	N. Carolina	6.90%	Wyoming	0.00%


Top Corporate Income Tax Rate
RATE
≤ 6%
6% to 7%
7% to 8%
8% to 9%
> 9%


Corporation Income
120.0%
100.0%
80.0%
60.0%
40.0%
20.0%
0.0%
-20.0%
-40.0%
-60.0%
-80.0%
-5.4%
-28.5%
34.1%
9.1%
57.8%
109.3%
-1.4%
-56.0%
-38.4%
-11.2%
26.4%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11


Corporation Income
Millions
$1,200
$1,000
$800
$600
$400
$200
$-
289.9
207.4
278.0
303.3
478.5
1,001.6
988.1
435.2
268.0
237.9
300.8
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11


Features of the original AMC, includes c-corps and LLE (including LLC and partnerships)
Tax liability: Greater of 1, 2 or 3
1
Net income
Net income
x 6.00%
= Net income tax
2
AMC
Lesser of two alternative minimum calculations
3
$175 minimum
$175
(absolute minimum)
2a
Gross receipts
Gross receipts
x 0.095%
= Gross receipts AMC
Or
2b
Gross profits
Gross receipts
- Cost of goods sold
Gross profit
x .75%
= Gross profits AMC

After HB 1: Corporations pay Corporate income tax, LLET pay individual income tax

Tax liability: Pay Both the LLET and Income, but get a credit from LLET against income tax

1 Net income

Net income
x 6.00%
= Net income tax

Non-refundable Credit

And

2 LLET

Lesser of two alternative minimum calculations

2a Gross receipts

Gross receipts
x 0.095%
= Gross receipts AMC

Or

2b Gross profits

Gross receipts
- Cost of goods sold
Gross profit
x .75%
= Gross profits AMC

House Bill 1 – 2006 Special Session

Credit for LLET given on Income Tax

1 Limited Liability Entity Tax

Lesser of two calculations with a minimum of $175

2 Net income

Net income
x 6.00%
= Net income tax

Less LLET Tax Credit

Credit = LLET Tax less $175 minimum. Limited to use against tax on income from the entity that paid the tax. Non-refundable. Does not carry forward.

Limited Liability Entity Tax

Imposition in KRS 141.0401

Tax Base: This tax applies to all entities which provide limited liability to their owners and is assessed for the privilege of doing business in Kentucky.

Tax Rate:

- ✓ Using the gross receipts method, the tax rate is nine and one-half cents per $100 of gross receipts
- ✓ Using the gross profits method, the tax rate is seventy-five cents per $100 of gross profits.
- ✓ If gross receipts or gross profits are less than $3.0 million, the minimum tax of $175 is due.
- ✓ For taxpayers with gross receipts between $3.0 millionand$6.0 million, a partial exemption is given.

Total Receipts:

Actual FY2011	$215.7 million
Tax Expenditures for FY2012	$116.1 million

Property Taxes

Imposition in KRS Chapter 132

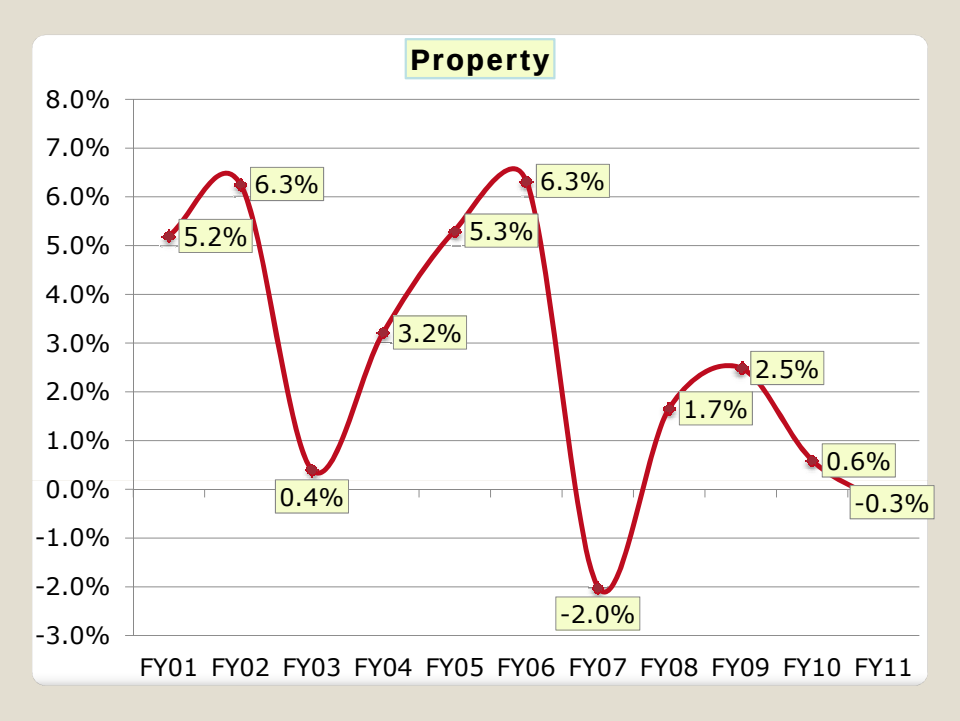
Tax Base: This tax applies to all entities which provide limited liability to their owners and is assessed for the privilege of doing business in Kentucky.

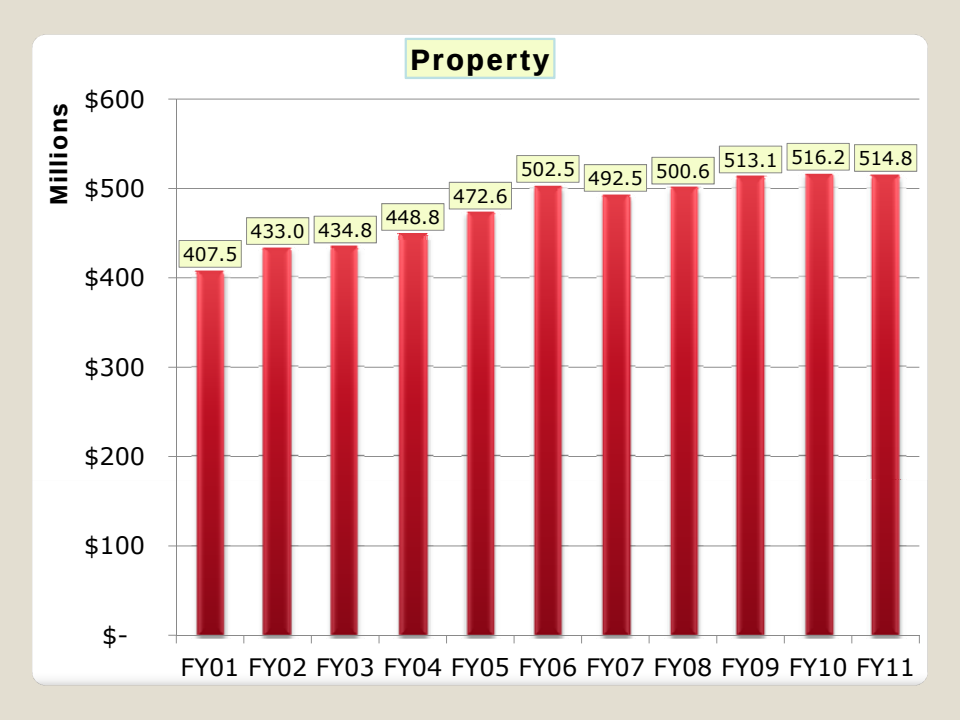
Tax Rate:

- ✓ Using the gross receipts method, the tax rate is nine and one-half cents per $100 of gross receipts
- ✓ Using the gross profits method, the tax rate is seventy-five cents per $100 of gross profits.
- ✓ If gross receipts or gross profits are less than $3.0 million, the minimum tax of $175 is due.
- ✓ For taxpayers with gross receipts between $3.0 millionand$6.0 million, a partial exemption is given.

Total Receipts:

Actual FY2011	$215.7 million
Tax Expenditures for FY2012	$116.1 million


Property
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
-3.0%
5.2%
6.3%
0.4%
3.2%
5.3%
6.3%
-2.0%
1.7%
2.5%
0.6%
-0.3%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11


Property
Millions
$600
$500
$400
$300
$200
$100
$-
407.5
433.0
434.8
448.8
472.6
502.5
492.5
500.6
513.1
516.2
514.8
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11

Quick Facts: Property Tax on Motor Vehicles

- ✓ **State Rate is 45 ¢ per $100 in valuation**
- ✓ **Valuation method: 100% Trade-in value NADA (HB 74, 1998)**
- ✓ **Assessment Date: January 1**
- ✓ **Payment Due: End of the birthday month for registered primary owner**
- ✓ **County, cities, schools, and special districts may also levy property taxes on motor vehicles**
- ✓ **State also assesses a registration fee, which is due when property taxes are paid. Annual fee was increased in HB 380 from $15 to $21 effective 1/1/07**
- ✓ **A repeal or reduction of the state portion of the vehicle property tax will negatively impact county clerks, who receive 4% of the value of property taxes collected.**

Constitutional amendment of 1998

"Notwithstanding the provisions of Sections 3, 172, and 174 of this Constitution to the contrary, the General Assembly may provide by law an exemption for all or any portion of the property tax for any class of personal property. "

Tobacco Taxes

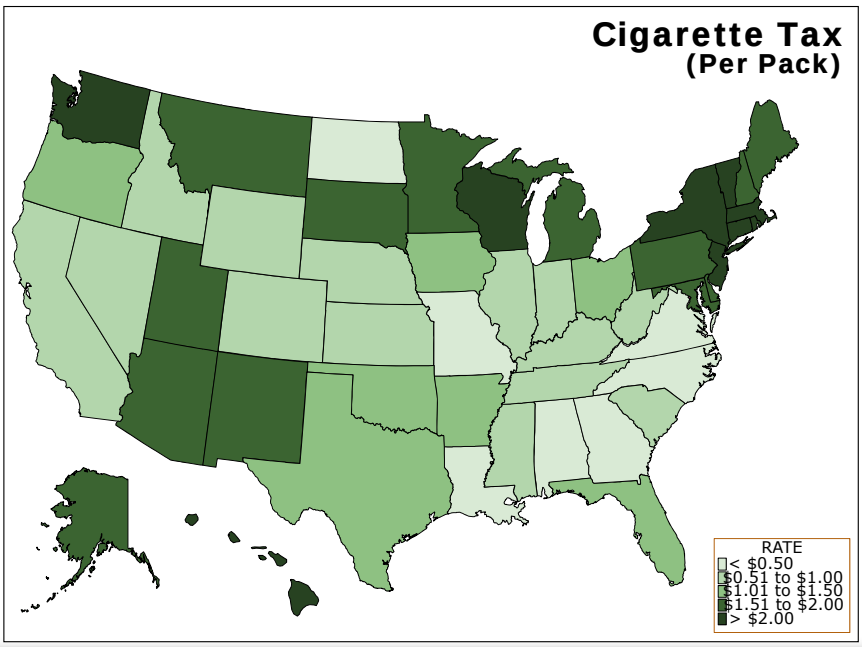
Imposition in KRS Chapter 138

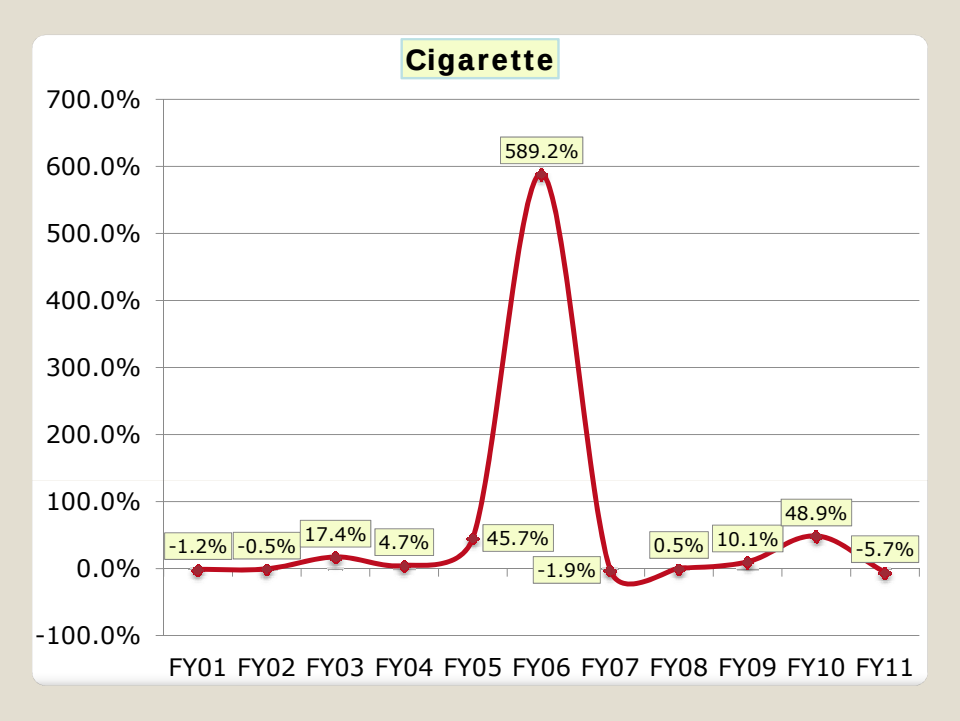
Tax Base: Both the cigarette excise tax and the cigarette surtax are paid through the purchase of stamps or meter units from the Department of Revenue. On other tobacco products, the wholesale taxes are paid at the point of the wholesale sales.

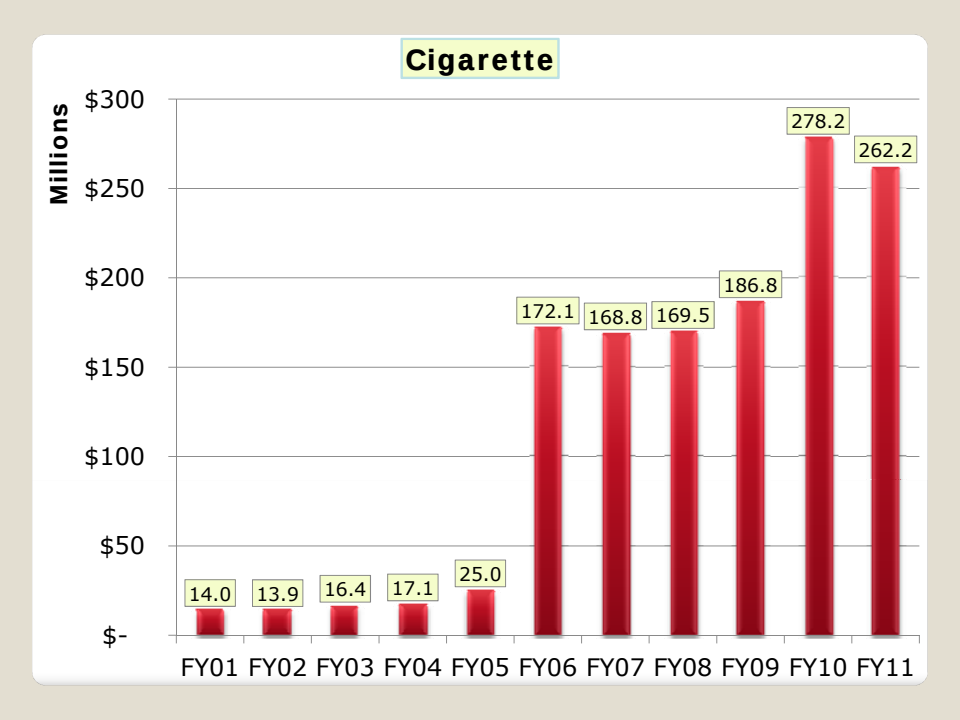
Tax Rate: Both the cigarette excise tax and the cigarette surtax, is sixty (60) cents per package of twenty cigarettes. The other tobacco products tax is 15.0 percent of gross receipts. The tax on snuff is 19 cents per unit.

Tax Receipts:

Actual FY2011	$283.8 million
Tax Expenditures for FY2012	$1.3 million




Cigarette
700.0%
600.0%
500.0%
400.0%
300.0%
200.0%
100.0%
0.0%
-100.0%
-1.2%
-0.5%
17.4%
4.7%
45.7%
589.2%
-1.9%
0.5%
10.1%
48.9%
-5.7%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11


Cigarette
Millions
$300
$250
$200
$150
$100
$50
$-
14.0
13.9
16.4
17.1
25.0
172.1
168.8
169.5
186.8
278.2
262.2
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11

Cigarette Tax (per pack)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	$ 0.43	**Kentucky**	$ 0.60	N. Dakota	$ 0.44
Alaska	$ 2.00	Louisiana	$ 0.36	Ohio	$ 1.25
Arizona	$ 2.00	Maine	$ 2.00	Oklahoma	$ 1.03
Arkansas	$ 1.15	Maryland	$ 2.00	Oregon	$ 1.18
California	$ 0.87	Mass.	$ 2.51	Penn.	$ 1.60
Colorado	$ 0.84	Michigan	$ 2.00	R. Island	$ 3.46
Connecticut	$ 3.40	Minnesota	$ 1.59	S. Carolina	$ 0.57
Delaware	$ 1.60	Mississippi	$ 0.68	S. Dakota	$ 1.53
Florida	$ 2.86	Missouri	$ 0.17	Tennessee	$ 0.62
Georgia	$ 1.34	Montana	$ 1.70	Texas	$ 1.41
D.C.	$ 0.37	Nebraska	$ 0.64	Utah	$ 1.70
Hawaii	$ 3.20	Nevada	$ 0.80	Vermont	$ 2.62
Idaho	$ 0.57	N. Hampshire	$ 1.68	Virginia	$ 0.30
Illinois	$ 0.98	New Jersey	$ 2.70	Washington	$ 3.03
Indiana	$ 1.00	N. Mexico	$ 1.66	W. Virginia	$ 0.55
Iowa	$ 1.36	N. York	$ 4.35	Wisconsin	$ 2.52
Kansas	$ 0.79	N. Carolina	$ 0.45	Wyoming	$ 0.60

Spirits Tax (per gallon)

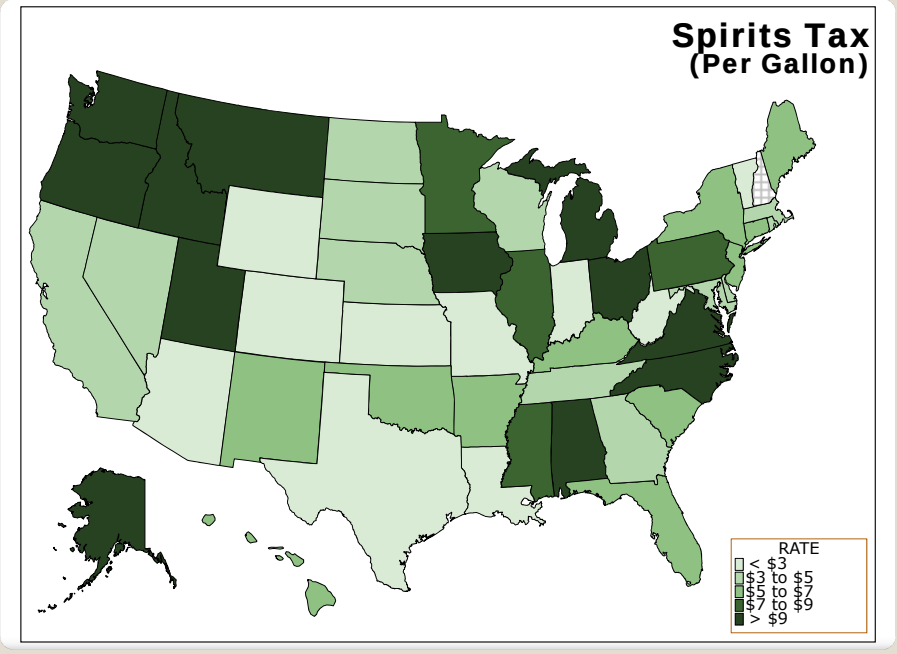
STATE	RATE	STATE	RATE	STATE	RATE
Alabama	$ 18.61	**Kentucky**	$ 6.85	N. Dakota	$ 4.66
Alaska	$ 12.80	Louisiana	$ 2.50	Ohio	$ 10.16
Arizona	$ 3.00	Maine	$ 6.15	Oklahoma	$ 5.56
Arkansas	$ 6.52	Maryland	$ 4.45	Oregon	$ 23.03
California	$ 3.30	Mass.	$ 4.05	Penn.	$ 7.57
Colorado	$ 2.28	Michigan	$ 13.24	R. Island	$ 3.75
Connecticut	$ 5.40	Minnesota	$ 8.88	S. Carolina	$ 5.42
Delaware	$ 3.75	Mississippi	$ 8.43	S. Dakota	$ 4.68
Florida	$ 5.43	Missouri	$ 2.00	Tennessee	$ 4.46
Georgia	$ 6.50	Montana	$ 9.45	Texas	$ 2.40
D.C.	$ 3.79	Nebraska	$ 3.75	Utah	$ 11.63
Hawaii	$ 5.98	Nevada	$ 3.60	Vermont	$ 0.32
Idaho	$ 11.28	N. Hampshire	$ -	Virginia	$ 20.91
Illinois	$ 8.55	New Jersey	$ 5.50	Washington	$ 26.70
Indiana	$ 2.68	N. Mexico	$ 6.06	W. Virginia	$ 2.55
Iowa	$ 13.18	N. York	$ 6.44	Wisconsin	$ 3.25
Kansas	$ 2.50	N. Carolina	$ 13.03	Wyoming	$ 0.83

Table Wine Tax (per gallon)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	$ 1.700	**Kentucky**	$ 0.500	N. Dakota	$ 1.060
Alaska	$ 2.500	Louisiana	$ 0.110	Ohio	$ 0.320
Arizona	$ 0.840	Maine	$ 0.600	Oklahoma	$ 0.720
Arkansas	$ 1.390	Maryland	$ 1.400	Oregon	$ 0.670
California	$ 0.200	Mass.	$ 0.550	Penn.	$ -
Colorado	$ 0.320	Michigan	$ 0.510	R. Island	$ 0.600
Connecticut	$ 0.720	Minnesota	$ 1.210	S. Carolina	$ 1.080
Delaware	$ 0.970	Mississippi	$ -	S. Dakota	$ 1.210
Florida	$ 1.630	Missouri	$ 0.420	Tennessee	$ 1.270
Georgia	$ 2.250	Montana	$ 1.060	Texas	$ 0.200
D.C.	$ 1.510	Nebraska	$ 0.950	Utah	$ -
Hawaii	$ 1.380	Nevada	$ 0.700	Vermont	$ 0.550
Idaho	$ 0.450	N. Hampshire	$ -	Virginia	$ 1.510
Illinois	$ 1.390	New Jersey	$ 0.880	Washington	$ 0.880
Indiana	$ 0.470	N. Mexico	$ 1.700	W. Virginia	$ 1.000
Iowa	$ 1.750	N. York	$ 0.300	Wisconsin	$ 0.250
Kansas	$ 0.300	N. Carolina	$ 0.790	Wyoming	$ -

Beer Tax (per gallon)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	$ 1.050	**Kentucky**	$ 0.080	N. Dakota	$ 0.390
Alaska	$ 1.070	Louisiana	$ 0.320	Ohio	$ 0.180
Arizona	$ 0.160	Maine	$ 0.350	Oklahoma	$ 0.400
Arkansas	$ 0.310	Maryland	$ 0.440	Oregon	$ 0.080
California	$ 0.200	Mass.	$ 0.110	Penn.	$ 0.080
Colorado	$ 0.080	Michigan	$ 0.200	R. Island	$ 0.110
Connecticut	$ 0.230	Minnesota	$ 0.480	S. Carolina	$ 0.770
Delaware	$ 0.160	Mississippi	$ 0.430	S. Dakota	$ 0.270
Florida	$ 0.560	Missouri	$ 0.060	Tennessee	$ 0.140
Georgia	$ 0.480	Montana	$ 0.140	Texas	$ 0.200
D.C.	$ 1.010	Nebraska	$ 0.310	Utah	$ 0.410
Hawaii	$ 0.930	Nevada	$ 0.160	Vermont	$ 0.270
Idaho	$ 0.150	N. Hampshire	$ 0.300	Virginia	$ 0.260
Illinois	$ 0.230	New Jersey	$ 0.120	Washington	$ 0.260
Indiana	$ 0.120	N. Mexico	$ 0.410	W. Virginia	$ 0.180
Iowa	$ 0.190	N. York	$ 0.140	Wisconsin	$ 0.060
Kansas	$ 0.180	N. Carolina	$ 0.530	Wyoming	$ 0.020


Spirits Tax
(Per Gallon)
RATE
< $3
$3 to $5
$5 to $7
$7 to $9
> $9

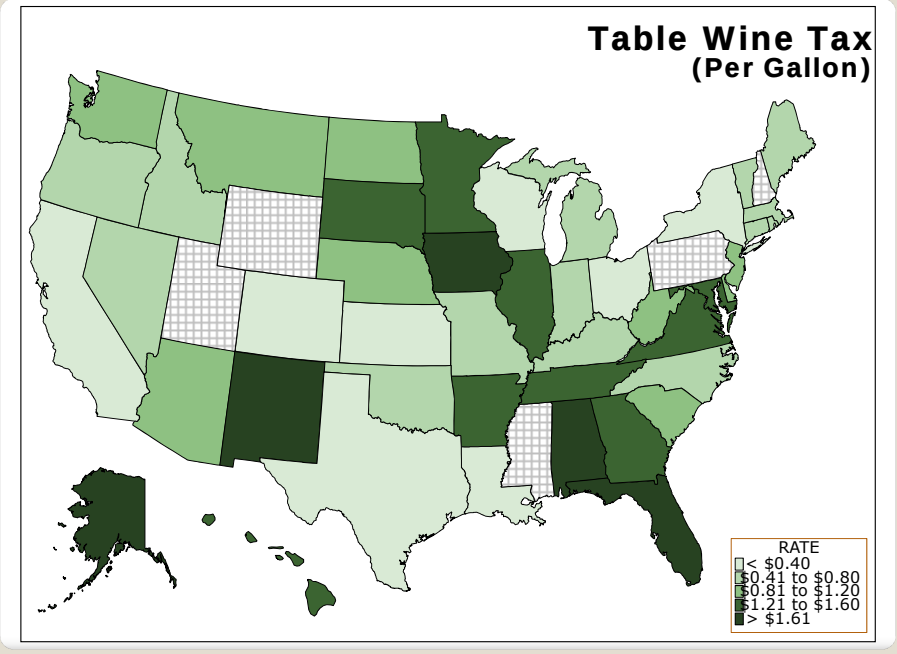
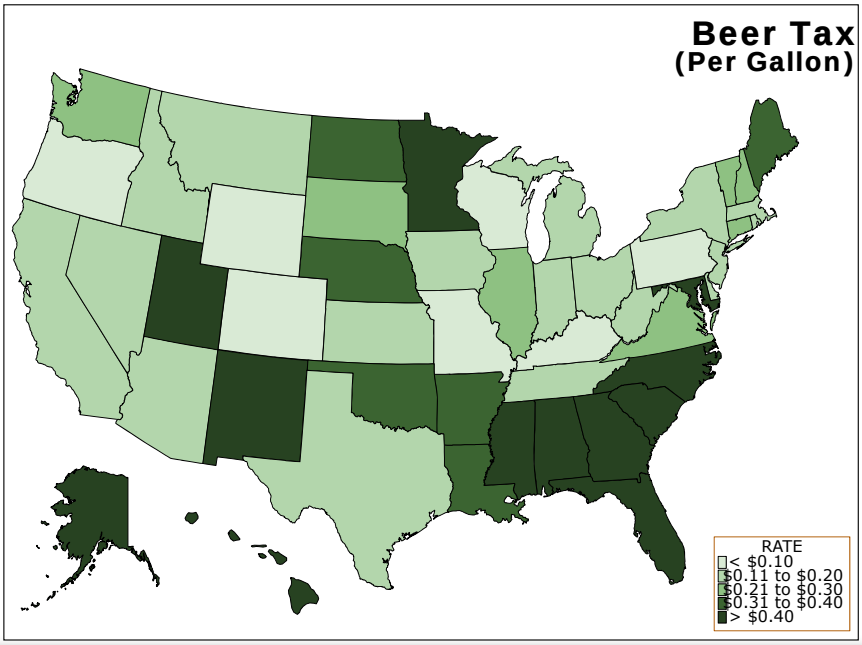
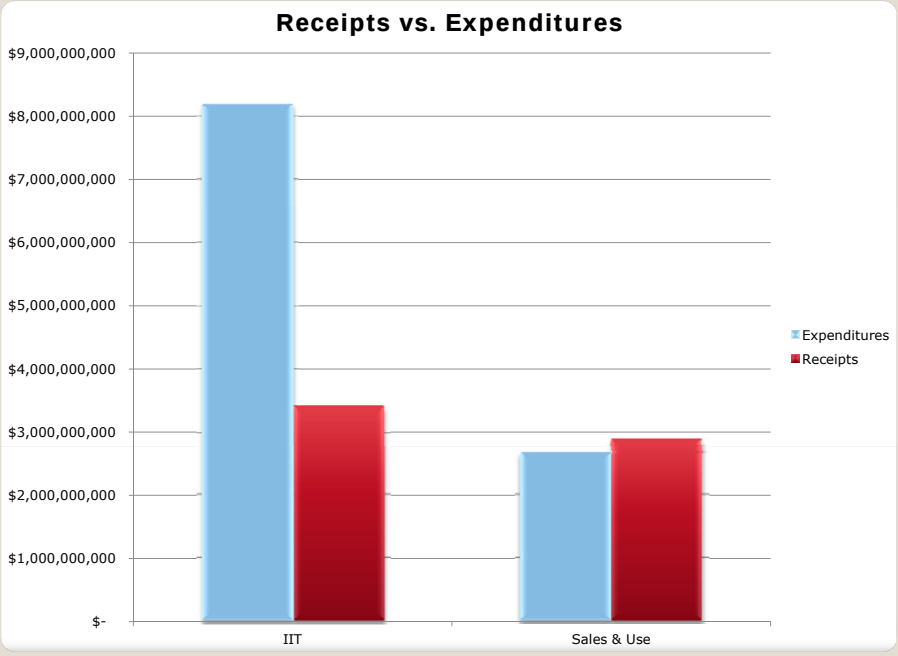


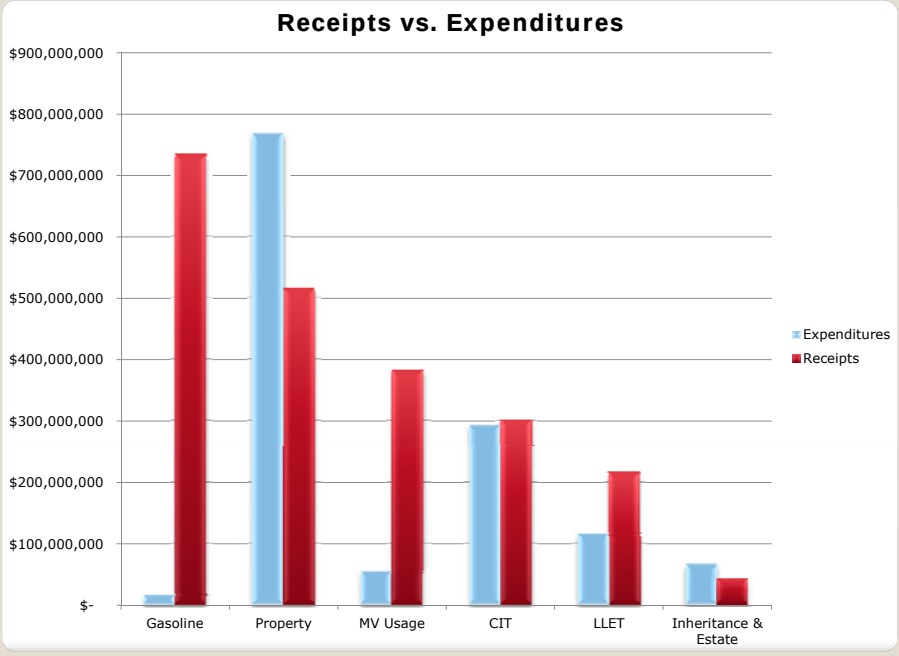
Table Wine Tax
(Per Gallon)
RATE
< $0.40
$0.41 to $0.80
$0.81 to $1.20
$1.21 to $1.60
> $1.61



Gasoline Tax (per gallon)

STATE	RATE	STATE	RATE	STATE	RATE
Alabama	$ 0.209	**Kentucky**	$ 0.278	N. Dakota	$ 0.230
Alaska	$ 0.008	Louisiana	$ 0.200	Ohio	$ 0.280
Arizona	$ 0.190	Maine	$ 0.315	Oklahoma	$ 0.170
Arkansas	$ 0.218	Maryland	$ 0.235	Oregon	$ 0.310
California	$ 0.486	Mass.	$ 0.235	Penn.	$ 0.323
Colorado	$ 0.220	Michigan	$ 0.394	R. Island	$ 0.330
Connecticut	$ 0.486	Minnesota	$ 0.281	S. Carolina	$ 0.168
Delaware	$ 0.230	Mississippi	$ 0.188	S. Dakota	$ 0.240
Florida	$ 0.235	Missouri	$ 0.173	Tennessee	$ 0.214
Georgia	$ 0.350	Montana	$ 0.278	Texas	$ 0.200
D.C.	$ 0.294	Nebraska	$ 0.276	Utah	$ 0.245
Hawaii	$ 0.471	Nevada	$ 0.331	Vermont	$ 0.261
Idaho	$ 0.250	N. Hampshire	$ 0.196	Virginia	$ 0.198
Illinois	$ 0.389	New Jersey	$ 0.145	Washington	$ 0.375
Indiana	$ 0.389	N. Mexico	$ 0.189	W. Virginia	$ 0.334
Iowa	$ 0.220	N. York	$ 0.490	Wisconsin	$ 0.329
Kansas	$ 0.250	N. Carolina	$ 0.392	Wyoming	$ 0.140


Receipts vs. Expenditures
$9,000,000,000
$8,000,000,000
$7,000,000,000
$6,000,000,000
$5,000,000,000
$4,000,000,000
$3,000,000,000
$2,000,000,000
$1,000,000,000
$-
IIT
Sales & Use
Expenditures
Receipts


Receipts vs. Expenditures
$900,000,000
$800,000,000
$700,000,000
$600,000,000
$500,000,000
$400,000,000
$300,000,000
$200,000,000
$100,000,000
$-
Gasoline
Property
MV Usage
CIT
LLET
Inheritance & Estate
Expenditures
Receipts

	Sales & Use Proposals	Recommendation by:	Status:
1	Broaden the sales tax to include most services	Common recommendation	selective services
2	Allow food to remain exempt from the tax.	Commission on Tax Policy, Others	Remains exempt.
3	Eliminate special exemptions offered to certain industries, including agriculture industry	Commission on Tax Policy, Bill Fox	No action
4	Achieve more uniform taxation of final consumption	Long-Term Policy Research, Bill Fox	No action
5	Eliminate double-taxation of intermediate-goods	Long-Term Policy Research, Bill Fox	No action
6	Encourage the Congressional delegation to support a new nexus standard	Bill Fox	No action
7	Impose a sales tax collection responsibility on dot-com companies that are part of the same corporate structure	Bill Fox	Implemented
8	Investigate alternatives for enhancing use tax compliance through improved tax auditing	Bill Fox	Implemented for certain industries
9	Impose tax on unbundled natural gas transactions and dot.com affiliates of retailers	Governor Patton's Administration	Implemented
10	Join the Streamlined Sales and Use Tax Initiative	Governor Patton's Administration	Implemented
11	Limit vendor compensation at $1,500 per reporting period	Governor Patton's Administration	Implemented
12	Raise the tax rate to 7%, legalize Video Lottery Terminals, then roll-back the sales tax to 6% after 2 years	Governor Patton's Administration	No action
13	Eliminate the tax on switch access fees paid by communications companies	Governor Patton's Administration	Implemented
14	Assess sales tax on DBS services at a 7% tax rate	Governor Patton's Administration	Implemented

	Property Proposals	Recommendation by:	Status:
1	Repeal the Intangible Property Tax	1982 Revenue Cabinet, Commission on Tax Policy, Governor Patton's Admin.	Implemented
2	Exempt unmined coal	Commission on Tax Policy	No action
3	Tax all real property at full state and local rates	Commission on Tax Policy	No action
4	Modify House Bill 44 and freeze the real property tax rate	Commission on Tax Policy, Bill Fox, Governor Patton's Administration	No action
5	Make PVAs part of the Revenue Cabinet merit system and turn over collection of property taxes to the Revenue Cabinet	Commission on Tax Policy	No action
6	Eliminate burdensome administration – PVAs and Sheriffs	Commission on Tax Policy	No action
7	Repeal the public service corporation (PSC) property tax and subject these corporations to the Kentucky License Tax	Commission on Tax Policy	The License Tax is repealed
8	Eliminate the state property tax on motor vehicles/boats	Bill Fox, Governor Patton's Administration	No action
9	Exclude new property from the rate setting calculations	Governor Patton's Administration, Bill Fox	Implemented

Taxation Boot Camp

Presentation to the

Governor's Blue Ribbon Commission on Tax Reform

06 March 2012

Greg Harkenrider
Deputy Executive Director
Governor's Office for Economic Analysis
Office of State Budget Director
Osbd.ky.gov

Prior Tax Reform Initiatives

Presentation to the

Governor's Blue Ribbon Commission on Tax Reform

10 April 2012

Greg Harkenrider
Deputy Executive Director
Governor's Office for Economic Analysis
Office of State Budget Director
Osbd.ky.gov

Today's Road Map

- ✓ **Litany of prior tax reform efforts**
- ✓ **A closer examination, tax by tax**
- ✓ **Effects on optimal taxation**
  - ✓ Elasticity,
  - ✓ Simplicity and compliance,
  - ✓ Fairness or Equity,
  - ✓ Competitiveness,
  - ✓ Adequacy;

Previous Studies

- ✓ November 3, 1982, *A Proposal to Reform and Simplify the Kentucky Tax System, (A Flat Rate Individual Income Tax and A corporate Business Activity Tax to Replace Eight Existing Taxes),* Revenue Cabinet.
- ✓ April, 1983, *A Proposal to Reform and Simplify the Kentucky Individual Income Tax System,* Revenue Cabinet.
- ✓ February 8, 1990, *Governor Wilkinson's Revenue Revitalization Program: Questions and Answers,* Finance and Administration Cabinet.
- ✓ November, 1995, *A Blueprint for Comprehensive Reform,* Kentucky Commission on Tax Policy.
- ✓ December, 1999, *A Comparative Analysis of Kentucky's Tax Structure,* Barents Group, LLC.
- ✓ December, 2001, *Financing State and Local Government: Future Challenges and Opportunities,* Kentucky Long-Term Policy Research Center.

Previous Studies

- ✓ Report to the Sub-Committee on Tax Policy Issues, William F. Fox. February, 2002.
- ✓ Securing Kentucky's Future, Governor Paul E. Patton's administration, January, 2003.
- ✓ Solving Kentucky's Fiscal Crisis, Governor Paul E. Patton's administration, November, 2003.
- ✓ Kentucky's Economic Competitiveness, A Call for Modernization of the State's Fiscal Policies, Paul Coomes, Ph.D., November, 2004.
- ✓ Governor Fletcher's Jobs and Opportunity Bipartisan Solution (JOBS) for Kentucky, State Budget Director's Office, January, 2005.
- ✓ Final Report of the Task Force on Local Taxation, House Bill 272, Legislative Research Commission, June 27, 2006.

Individual Income Base and Rates

History of Reforms

- ✓ Imposed in 1936
- ✓ Imposed withholding in 1954
- ✓ Adopted federal definition of taxable income in 1954
- ✓ Biggest Kentucky-based base reductions:
  - ✓ Active duty military pay
  - ✓ Federal and military retirement income
  - ✓ Employer contributions to pension plans
  - ✓ Private pension income and IRA income
  - ✓ State pension contributions and benefits
  - ✓ Net operating losses
- ✓ Kentucky credits

Individual Income Base and Rates

History of Reforms

- ✓ During the Extraordinary Session of the General Assembly in 1936, Chapter 7 was passed and became law on May 8, 1936. It was retroactive to start on January 1, 1936. The Extraordinary Session lasted from March 9 until March 26 that year. The tax rate was on a graduated scale from 2% to the highest 5% for all income in excess of $5,000.
- ✓ In 1950, the General Assembly increased the income tax rate to help finance poor school districts. The new top rate was 6% on income over $8,000.
- ✓ Rates did not change again until 2005 when the rate for income over $8,000 but less than $75,000 was lowered to 5.8%. Top rate over $75,000 was 6%.

Individual Income Base and Rates

Effects on Optimal Taxation

- ✓ Raising the Top Marginal Rate
  - ✓ Fairness (Adds progressivity to an overall regressive system)
  - ✓ Competitiveness (Higher incomes arguably mobile)
  - ✓ Simplicity, Compliance (Neutral to Negative)
  - ✓ Elasticity
  - ✓ Adequacy
- ✓ Base Broadening
  - ✓ Fairness (Similar treatment of all sources of income)
  - ✓ Competitiveness (Higher incomes arguably mobile)
  - ✓ Simplicity, Compliance (Neutral)
  - ✓ Elasticity
  - ✓ Adequacy
- ✓ Cannot forget local taxation of incomes limits state

Income Taxes

- ✓ **Eliminate Income Tax**
  - ✓ Reduce or eliminate the individual income tax, to attract talented people and reduce the drain on disposable incomes of residents of the most urbanized parts of the state. ***Kentucky's Economic Competitiveness***
  - ✓ Merits to the Proposal
    - ✓ Helps competitiveness and simplicity
    - ✓ Attracts human capital formation, headquarter operations
  - ✓ Challenges to the proposal
    - ✓ Difficulty to raise other taxes enough to restore the lost revenue
    - ✓ Eliminates our most productive tax
    - ✓ Eliminates progressivity
    - ✓ Hurts Adequacy and Elasticity

Income Taxes

- **Expand Low Income Credit**
  - Increasing the threshold for our low-income tax credit while simultaneously eliminating a loophole that allows wealthier taxpayers who have high levels of "exempt" income to potentially qualify for the credit. ***Securing Kentucky's Future***
  - Expand Low Income Credit to 100% of Federal Poverty Guidelines. ***Solving Kentucky's Fiscal Crisis***
  - Increase the lowest bracket of the low income credit to exclude from tax a person whose income is at or below $12,000, adjust other brackets for this change, and clarify who is eligible for the credit. ***Governor Fletcher's (JOBS) for Kentucky***

Income Taxes Reform Issues

Adopt Federal adjusted gross income as the starting point for computing the Kentucky tax base and add back or subtract specific items to arrive at Kentucky taxable income	Common thread among all reports to increase simplicity	KY Adopted Federal AGI with additions and subtractions
Update to the Internal Revenue Code (IRC), eliminate the federal tax deduction, and implement a low income tax credit	First suggested in the Governor Wilkinson's Proposal; various later proposals to tweak Low-income tax credit	IRC date is 12/31/06, federal tax deduction eliminated, the low income tax credit implemented and modified
Adopt the federal filing status	Commission on Tax Policy	No action
Adopt the federal standard deduction, personal exemptions, and eliminate the low income credit	Commission on Tax Policy	No action

Income Taxes Reform Issues

Retain current itemized deductions	Commission on Tax Policy	Itemized deductions retained
Adopt a flat 6% rate structure on income as modified	Commission on Tax Policy	No action, but a new bracket was created in 2005
Increase the threshold for the low-income tax credit while simultaneously eliminating a loophole that allows wealthier taxpayers who have high levels of exempt income to potentially qualify for the credit	Governor Patton's Administration, Bill Fox	Modified AGI is used to determine eligibility for the Family Size Tax Credit
Phase out the tax-exempt status for a large portion of retirement income for higher-income retirees or phase out the pension exclusion and index for inflation	Governor Patton's Administration, Bill Fox	Pension exclusion capped at $41,110; the inflation adjustment is deleted
Eliminate the deduction for taxes paid to a foreign country	Governor Patton's Administration, Bill Fox	Implemented

Income Taxes Reform Issues

Expand the low income tax credit to 100% of federal poverty guidelines	Governor Patton's Administration	Expanded and modified based on family size
Reduce or eliminate the individual income tax, to attract talented people and reduce the drain on disposable incomes of residents of the most urbanized parts of the state	Paul Coomes	An additional bracket at 5.8% is added; top rate remains at 6%
Increase the lowest bracket of the low income credit to exclude from tax a person whose income is at or below $12,000, adjust other brackets for this change, and clarify who is eligible for the credit	JOBS for KY	Expanded and modified based on family size
Reduce the top rate of tax to 5.68% or lower	JOBS for KY	Income tax rate for $8,000 to $75,000 is 5.8%; above $75,000 is 6%

Sales Tax Base and Rates

History of Reforms

- ✓ Imposed in 1960 after an unsuccessful attempt in the 1930's
  - ✓ Gross receipts tax in 1934 (3%)
  - ✓ Repealed in 1936
  - ✓ Sales tax reinstated in 1960 (3%)
  - ✓ Rate increase in 1968 (5%)
  - ✓ Sales tax increased in 1990 (6%)
- ✓ Base narrowing started in 1966
- ✓ Food and Rx eliminated from base in 1972
- ✓ Selective base narrowing has occurred ever since

Sales Tax Base and Rates

Effects on Optimal Taxation

- ✓ Raising the Rate
  - ✓ Fairness (Regressive)
  - ✓ Competitiveness (Border Issues)
  - ✓ Simplicity, Compliance (Neutral, Negative)
  - ✓ Elasticity (May lower sales, but overall +)
  - ✓ Adequacy (Same argument as above)
- ✓Base Broadening
  - ✓ Fairness (Similar treatment of goods and services)
  - ✓ Competitiveness (Border Issues)
  - ✓ Simplicity, Compliance (Neutral)
  - ✓ Elasticity
  - ✓ Adequacy
- ✓Converse of each policy gets mirror image of effects
  - ✓Lower rate, broaden the base?

Sales and Use Tax Recommendations

Broaden the sales tax to include business services, and services in general	One of the most common and universal recommendations	Very selective services (e.g., transportation of natural gas)
Allow food to remain exempt from the tax.	Commission on Tax Policy, Others	Food remains exempt.
Eliminate special exemptions offered to certain industries and treat farm exemptions on par with other business exemptions	Commission on Tax Policy, Bill Fox	No action
Achieve more uniform taxation of final consumption (Transaction taxes verses selective sales tax on tangible goods).	Long-Term Policy Research, Bill Fox	No action
Eliminate the double-taxation present through taxation of intermediate-goods transactions	Long-Term Policy Research, Bill Fox	No action

Sales and Use Tax Recommendations

Encourage the Kentucky Congressional delegation to support a new nexus standard that requires remote vendors with substantial activity in the Commonwealth to collect tax on behalf of Kentucky	Bill Fox	No action
Impose a sales tax collection responsibility on dot-com companies that are part of the same corporate structure and have a similar name and that undertake similar business as companies that have nexus in Kentucky	Bill Fox	Implemented
Investigate alternatives for enhancing use tax compliance through improved tax auditing	Bill Fox	Implemented for certain industries

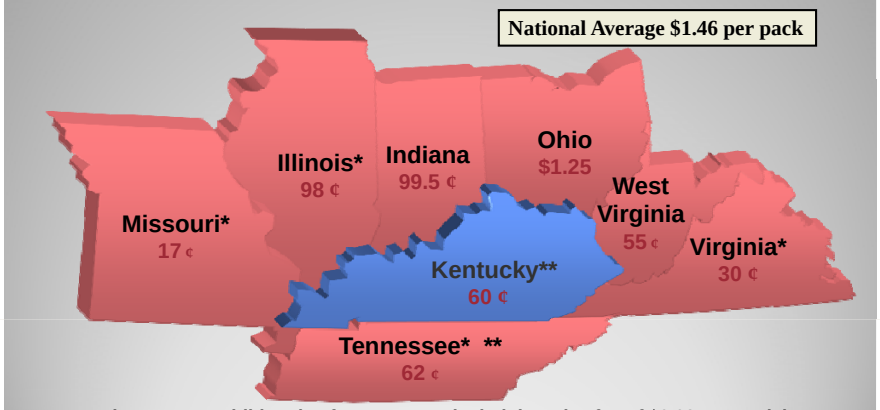
Sales and Use Tax Recommendations

Impose tax on unbundled natural gas transactions and dot.com affiliates of Kentucky retailers	Governor Patton's Administration	Implemented
Join the Streamlined Sales and Use Tax Initiative	Governor Patton's Administration	Implemented
Limit vendor compensation at $1,500 per reporting period	Governor Patton's Administration	Implemented
Raise the tax rate to 7%, legalize Video Lottery Terminals, then roll-back the sales tax to 6% after 2 years	Governor Patton's Administration	No action
Eliminate the tax on switch access fees paid by communications companies	Governor Patton's Administration	Implemented
Assess sales tax on DBS services at a 7% tax rate	Governor Patton's Administration	Implemented as part of Tax reform of 2005

Excise Taxes

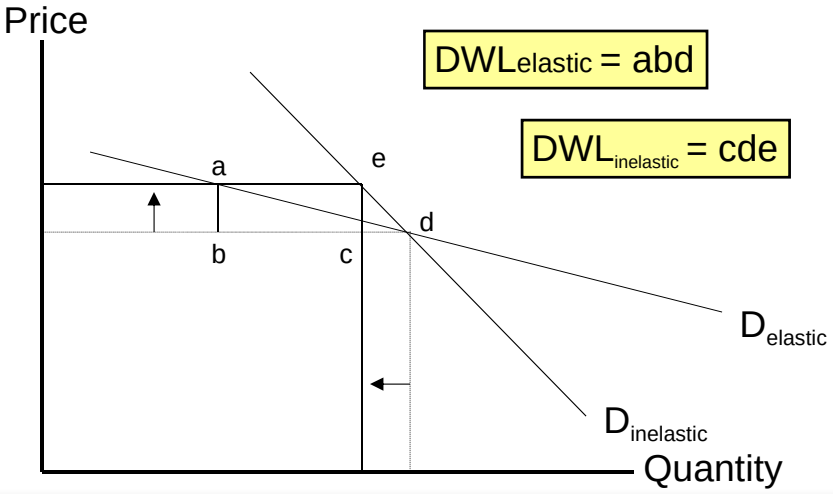
- Tobacco Taxes
  - Increase Taxes on Cigarettes
    - Report to the Sub-Committee on Tax Policy Issues
    - Securing Kentucky's Future
    - Solving Kentucky's Fiscal Crisis
    - Governor Fletcher's (JOBS) for Kentucky
  - Impose or Raise Taxes on Other Tobacco Products (cigars, rolling papers, snuff, etc.)
    - Report to the Sub-Committee on Tax Policy Issues
    - Securing Kentucky's Future
    - Solving Kentucky's Fiscal Crisis
    - Governor Fletcher's (JOBS) for Kentucky

State excise taxes on cigarettes

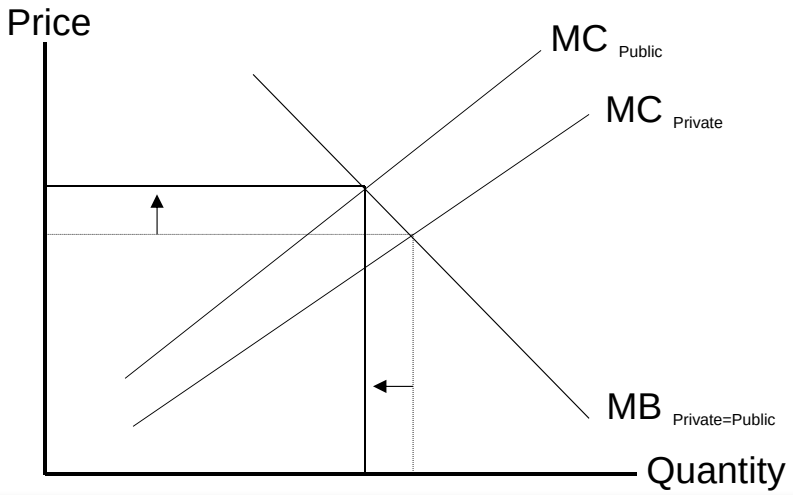


** Dealers pay an additional enforcement and administrative fee of $0.03 per pack in Kentucky and $0.05 in Tennessee.

Cigarette Taxes – Minimizes DWL



Cigarette Taxes – A Pigouvian Tax



Property Taxes

- **Property is taxed in Kentucky per Section 172 of the Constitution Section**
  - All property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at the price it would bring at a fair voluntary sale; and any officer, or other person authorized to assess values for taxation, who shall commit any willful error in the performance of his duty, shall be deemed guilty of misfeasance, and upon conviction thereof shall forfeit his office, and be otherwise punished as may be provided by law.
- **Constitution was amended in 1998**
  - "Notwithstanding the provisions of Sections 3, 172, and 174 of this Constitution to the contrary, the General Assembly may provide by law an exemption for all or any portion of the property tax for any class of personal property. "

Property Taxes

- ✓ **Real Property**
  - ✓ Freeze the state rate on Real Property.
    - ✓ ***Report to the Sub-Committee on Tax Policy Issues***
    - ✓ ***Securing Kentucky's Future***
    - ✓ ***Solving Kentucky's Fiscal Crisis***
  - ✓ Calculate the state real property tax limit by excluding new property before the four percent limit is imposed.
    - ✓ ***Report to the Sub-Committee on Tax Policy Issues***
    - ✓ ***Governor Fletcher's (JOBS) for Kentucky***

Property Taxes

- ✓ Elimination of Personal Property Taxes
  - ✓ Eliminate Property Taxes on motor vehicles and personal watercraft.
    - ✓ ***Report to the Sub-Committee on Tax Policy Issues***
    - ✓ ***Securing Kentucky's Future***
    - ✓ ***Solving Kentucky's Fiscal Crisis***
  - ✓ Eliminate Property Taxes on Intangible Property
    - ✓ ***Securing Kentucky's Future***
    - ✓ ***Solving Kentucky's Fiscal Crisis***
    - ✓ ***Governor Fletcher's (JOBS) for Kentucky***
  - ✓ Property tax on the aging of distilled spirits

Tangible Property Taxes

Line Item Code	Property Type	Rates for 2012
11-16	Schedule A	45¢ State & Full Local
17	Total of 11 through 16	45¢ State & Full Local
21-26	Schedule B	15¢ State Rate only
27	Total of 21 through 26	15¢ State Rate only
31	Merchants Inventory	5¢ State & Full Local Rates
32	Manufacturers Finished Goods	5¢ State & Full Local Rates
33	Manufacturers Raw Materials/Goods in Process	5¢ State Rate only
34	Motor Vehicles Held for Sale (dealers only) New Farm Machinery Held Under a Floor Plan New Boats & Marine Inventory (dealers only) Salvage Titled Vehicles (insurance companies only)	5¢ State Rate only
35	Goods Stored in Public Warehouse	5¢ State & Full Local Rates
36	Inventory – In Transit	Exempted from state rate, county, city, & school rates.
37	Unmanufactured Tobacco Products NOT AT PLANT/ Or in Hands of Grower or His Agent	1½¢ State & City, County
38	Other Unmanufactured Agri. Products NOT AT PLANT or in Hands of Grower or His Agent	1½¢ State & 4½¢ City & County
39	Unmanufactured Agri. Products AT PLANT or in Hands of Grower or His Agent/I. R. B. 's	1½¢ State Rate Only
40	Aircraft: non-commercial	1½¢ State & **LOCAL OPTION**
41	Watercraft: non-commercial	1½¢ State & **LOCAL OPTION**
50	Livestock & Farm Machinery/ Fluidized Bed Energy Facilities	$^{1}/_{10}$¢ State Rate Only
60	Schedule C - Other Tangible & Charter Aircraft & Non KY Registered Watercraft	45¢ State & Full Local Rates
70	Foreign Trade Zone	$^{1}/_{10}$¢ State Rate Only
81	Construction Work in Progress – mfg. machinery	15¢ State Rate only
82	Construction Work in Progress – other tangible	45¢ State & Full Local Rates
90	Recycling Machinery & Equipment	45¢ State Rate only

Prior Tax Reform Initiatives

Presentation to the

Governor's Blue Ribbon Commission on Tax Reform

10 April 2012

Greg Harkenrider
Deputy Executive Director
Governor's Office for Economic Analysis
Office of State Budget Director
Osbd.ky.gov

Options -- Tax Reform Initiatives

A Presentation to the Governor's Blue Ribbon Commission on Tax Reform

08 May 2012

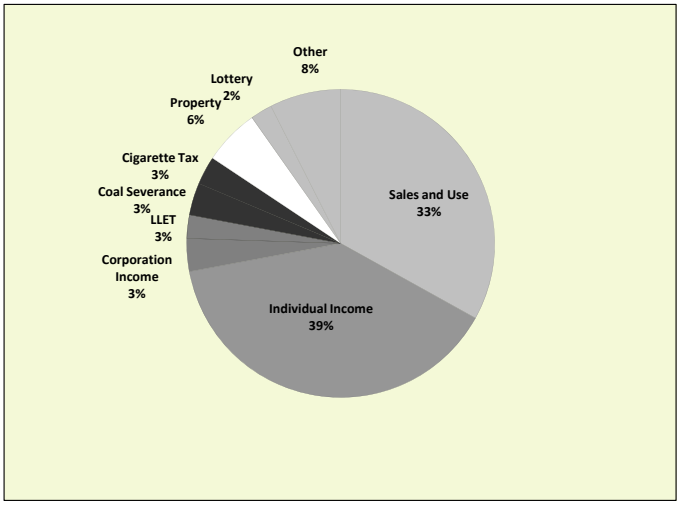
Greg Harkenrider
Office of State Budget Director
Governor's Office for Economic Analysis

General Fund Revenue

FY11 General Fund Revenues Compared to Previous Years

	Million $			Growth Rate (%)		
	FY11	**FY10**	**FY09**	**FY11**	**FY10**	**FY09**
Sales and Use	2,896.3	2,794.1	2,857.7	3.7	-2.2	-0.7
Individual Income	3,417.8	3,154.5	3,315.4	8.3	-4.9	-4.8
Corporation Income	300.8	237.9	268.0	26.4	-11.2	-38.4
LLET	215.7	145.9	121.7	47.8	20.0	23.6
Coal Severance	295.8	271.9	292.6	8.8	-7.1	25.6
Cigarette Tax	262.2	278.4	203.0	-5.8	37.1	19.8
Property	514.8	516.2	513.1	-0.3	0.6	2.5
Lottery	200.5	200.0	193.5	0.2	3.4	3.2
Other	655.5	626.2	661.4	4.7	-5.3	-2.6
TOTAL	**8,759.4**	**8,225.1**	**8,426.4**	**6.5**	**-2.4**	**-2.7**

General Fund Distribution



Sales Tax Base and Rates

Effects on Optimal Taxation

- Raising the Rate
  - Fairness (Regressive)
  - Competitiveness (Border Issues)
  - Simplicity, Compliance (Neutral, Negative)
  - Elasticity (May lower sales, but overall +)
  - Adequacy (Same argument as above)
- Base Broadening
  - Fairness (Similar treatment of goods and services)
  - Competitiveness (Border Issues)
  - Simplicity, Compliance (Neutral)
  - Elasticity
  - Adequacy
- Converse of each policy gets mirror image of effects
  - Lower rate, broaden the base?

Sales Tax Aggregate Changes

- Adding a penny, no base broadening
  - $510 million annually, recurring
  - May affect some existing credits
  - Viewed as regressive
  - KY has no local option sales tax (Gives head room on rate)
- Undue limited tax expenditures on goods
  - Food (ironically, about $500 million – as seen above)
  - Charity Purchases (about $370 million)
  - Prescription Drugs (about $400 million)
  - Residential Utilities (about $370 million)
  - Government Purchases (about $280 million)
- Broaden the base beyond goods

KY Currently Taxes Limited Services

- Services currently taxed in Kentucky
  - Certain Utilities
    - Telephone, electricity, water, gas, sewer, fuel, etc.
  - Admissions & Amusements
    - Pari-mutuel wagering, amusement park admission, circuses and fairs, admission to cultural or professional sporting events, video rental
  - Leases and Rentals
    - Personal property, construction machinery, tools, aircraft, lodging
  - Fabrication, Repair & Installation
    - Custom fabrication, materials used in repairs, custom processing, custom meat cutting, welding

25+ States Tax These Services:

- Short term automobile rental
- Long term automobile lease
- Commercial linen supply
- Service contracts sold at the time of sale of TPP.
- Sign construction and installation
- Software - modifications to canned program
- Trailer parks – overnight
- Billiard parlors
- Bowling alleys
- Cable TV services
- Taxidermy
- Auto service. except repairs, incl. painting & lube
- Automotive rustproofing & undercoating.

20+ States Tax These Services

- Software -
- Direct Satellite TV
- Repair labor, generally
- Labor on radio / TV repairs
- Labor charges - repairs on goods
- Other fuel (including heating oil)
- Diaper service
- Commercial art and graphic design.
- Membership fees in private clubs.
- Installation charges
- Electricity
- Natural gas
- Health clubs, tanning parlors, etc

- Laundry and dry cleaning services
- Admission to school and college sports events
- Landscaping services
- Typesetting service
- Gift and package wrapping service
- Extermination Services
- Automotive washing and waxing.
- Parking lots & garages
- Labor charges on vehicle repair
- Garment services
- Shoe repair
- Telephone answering service

15+ States Tax These Services

- Automotive storage
- Carpet and upholstery cleaning
- Maintenance and janitorial services
- Window cleaning
- Automotive road service and towing services
- Pinball and other mechanical amusements
- Pet grooming
- Security services
- Installation charges - other than seller of goods
- Marina Service (docking, storage, cleaning, repair)
- Swimming pool cleaning & maintenance
- Coin operated video games
- Fur storage
- Armored car services
- Private investigation (detective) services
- Limousine service (with driver)
- Labor charges on repair of aircraft
- Labor - repairs to commercial fishing vessels
- Labor - repairs or remodeling of real property

10+ States Tax These Services

- Mini -storage
- Software services
- Carpentry, building trades
- Household goods storage
- Cold storage
- Funeral services
- Water softening and conditioning
- Credit information, credit bureaus
- Information services
- Gross income of interior contractors
- Exterior construction service (grading, excavating, etc.)
- Water delivery
- Swimming pool cleaning & maintenance
- Coin operated video games
- Fur storage
- Armored car services
- Private investigation (detective) services
- Limousine service (with driver)
- Labor charges on repair of aircraft
- Labor - repairs to commercial fishing vessels
- Labor - repairs or remodeling of real property

Individual Income Base and Rates

Effects on Optimal Taxation

- Raising the Top Marginal Rate
  - Fairness (Adds progressivity to an overall regressive system)
  - Competitiveness (Higher incomes arguably mobile)
  - Simplicity, Compliance (Neutral to Negative)
  - Elasticity
  - Adequacy
- Base Broadening
  - Fairness (Similar treatment of all sources of income)
  - Competitiveness (Higher incomes arguably mobile)
  - Simplicity, Compliance (Neutral)
  - Elasticity
  - Adequacy
- Cannot forget local taxation of income

Individual Income Base and Rates

History of Reforms

- Imposed in 1936
- Imposed withholding in 1954
- Adopted federal definition of taxable income in 1954
- Biggest base reductions:
  - Active duty military pay (2010, $18.6 million)
  - Federal and military retirement income (1995, $67.0 million)
  - Employer contributions to pension plans (1983, $520 million)
  - Private pension income and IRA income (1995, $940 million)
  - State pension contributions and benefits
  - Net operating losses
  - Economic development credits

Income Taxes

- ✓ Options for reform include the following:
  - ✓ Base Broadening
    - ✓ Pension income (+ $350 million) Note: Feds tax pensions
    - ✓ Capital gains transferred at death (+ $700 million)
    - ✓ Disability income (+ $400 million)
    - ✓ Home mortgage interest (+ 1.3 billion)
  - ✓ Expanded low-income relief
    - ✓ Higher exemptions
    - ✓ Refundable relief
    - ✓ Expand credits
  - ✓ Rate alterations
    - ✓ Highest marginal rate
    - ✓ Bracket tweaking

Taxation of Pension Income

Example of Base Broadening

- Fiscal Impact roughly $350 million (public and private pensions)
  - Pros:
    - Legal challenges vetted in 2002
    - Can be refined to aid low-income pensioners
    - Pension income federally taxable
  - Cons:
    - Disincentive for domiciled retirement (overstated)
    - Politically difficult demographic to tax

Taxation of Pension Income

- Most states that levy a personal income tax allow people who receive retirement income to exclude part of it from their taxable income
- Of the 41 states with a broad based income tax, 36 offer exclusions for pension income
- Some states limit exclusion of pension income when significant non-pension income is reported
- While policies vary widely, all state exclusions of some pension income have one of two purposes:
  - Protecting the income of those no longer in the workforce
  - Economic development – to attract or retain retirees

Low-Income Tax Credit

Base Narrowing

- Strong Incentives on both sides of the issue
  - Pros:
    - Adds progressivity (very few options in other taxes)
    - Ability to tie to earned income
    - Cheaper than bracket changes
  - Cons:
    - Unintended consequences (Not all filers with low KY income are “poor”)
    - Does not help the middle class
    - Redistribution arguably a federal tax responsibility
      - Not many states have adopted “refundable” credits
      - State lost revenue must be replaced

Earned Income Tax Credit

- The federal EITC is a tax credit extended to low-wage workers The federal EITC was enacted in 1975 and made permanent law in 1978
- The tax filer must be working and earning wages in order to qualify
- The credit benefits families with children the most, and the value of the credit varies depending upon family size and income level
- For tax year 2011 the maximum benefit levels were as follows:
  - $5,112 for a family with two children with incomes from $12,750 to $21,750 (or $16,700 if single)
  - $3,094 for a family with one child with incomes from $9,100 to $21,800 (or $16,700 if single)
  - $464 for a married couple with no children and incomes from $6,050 to $7,600 (or $12,700 if single)

Earned Income Tax Credit

State Earned Income Tax Credits

- Most states that have enacted state EITCs, the credit is set as a percentage of the federal EITC
- Allows the credit to be implemented with little administrative cost
- State credits range from 3.5 percent to 34 percent of the federal credit
- Most states with an EITC follow federal provisions in establishing how large the credit is that each type of family receives

Earned Income Tax Credit

State Earned Income Tax Credits

- In 2005, Kentucky established a nonrefundable, family size tax credit
- Provides income tax relief for individuals and married couples earning less than 133 percent of the federal poverty level
- Kentucky's credit does not carry all of the benefits of a state EITC
- Main criticism is Kentucky's credit is non-refundable and does not provide a wage supplement

Earned Income Tax Credit

Surrounding States' Earned Income Tax Credits

- Indiana – State EITC is 9% of federal EITC
- Illinois - State EITC is 5% of federal EITC, increasing to 10% over the next three tax years
- Virginia – State EITC is 20% of federal EITC, but is non-refundable

Corporate Income Base and Rates

History of Reforms

- Current Rate Structure
  - Prior to 2006 top rate was 8.25%
  - After Tax Modernization top rate (>$100,00 taxable profits) phased down to 6%
- Tax Base
  - Definition of corporation changed in 2005
  - Change reversed in 2006
  - Pass-through entities returned to former status
- LLET
  - Lesser of
    - Rate of $950 per $1 Million on gross profits
    - Rate of $7,500 per $1 Million of gross receipts
  - Small business standard of $3 Million GP or GR
- Payment of the LLET creates a dollar-for-dollar credit against income taxation

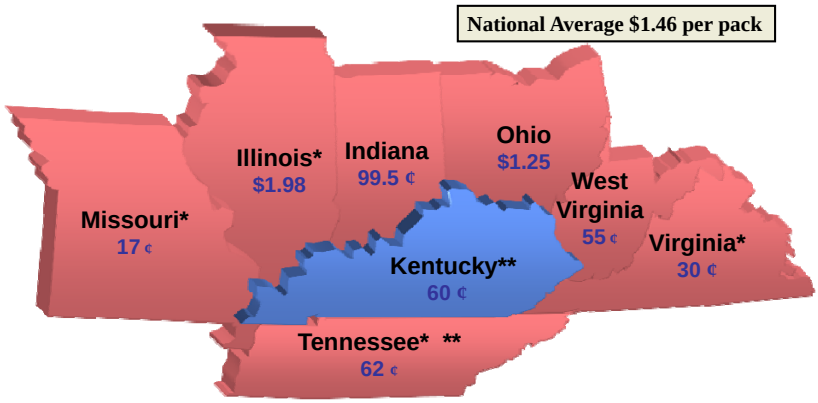
Corporate Income Expenditures

- Aggregate Tax Expenditure: ~$300,000,000
- Major Expenditures
  - Dividend Income ~$150,000,00
  - Net Operating Loss (NOL) Deduction ~$40,000,000
  - Charitable Contributions ~$10,000,000
  - Credit Unions ~6,000,000
  - Patronage Dividends ~$13,000,000
- Reforms suggested in the past
  - Repeal of income-based taxation
  - Change to *de minimus* standards
  - Tightening loopholes

Excise Taxes

- ✓ Options for reform include the following:
  - ✓ Raising the cigarette tax
    - ✓ Currently $0.60 per pack (plus sales tax)
    - ✓ Tax generates $280 million in excise and surtax revenue
    - ✓ Going to $0.80 (about $75 to $80 million)
    - ✓ Going to $1.00 per pack (about $120 million)
  - ✓ Other tobacco products
    - ✓ Currently 15% of wholesale price
    - ✓ Moist snuff at 19 cents per 1.2 ounce tin
    - ✓ Roll-your-own issues
  - ✓ Alcohol Taxes
    - ✓ Advocates want income tax credit to recover all property tax
    - ✓ Need to educate industry on recovery of local property tax

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.

Property Tax Reform

- ✓ Kentucky is considered a low property-tax state
- ✓ Options for reform:
  - ✓ Freeze the state rate on Real Property.
    - ✓ ***Report to the Sub-Committee on Tax Policy Issues***
    - ✓ ***Securing Kentucky's Future***
    - ✓ ***Solving Kentucky's Fiscal Crisis***
  - ✓ Partial relief on tangible property (especially property taxed at the state level only)
  - ✓ Consolidation, elimination, simplification, compliance issues

Tangible Property Taxes

LINE ITEM CODE	PROPERTY TYPE	RATES FOR 2012
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Options -- Tax Reform Initiatives

A Presentation to the Governor's Blue Ribbon Commission on Tax Reform

08 May 2012

Greg Harkenrider
Office of State Budget Director
Governor's Office for Economic Analysis

Economic Geography Issues

and implications for fiscal policies in Kentucky

Paul Coomes, Ph.D.
Professor of Economics
May 8, 2012

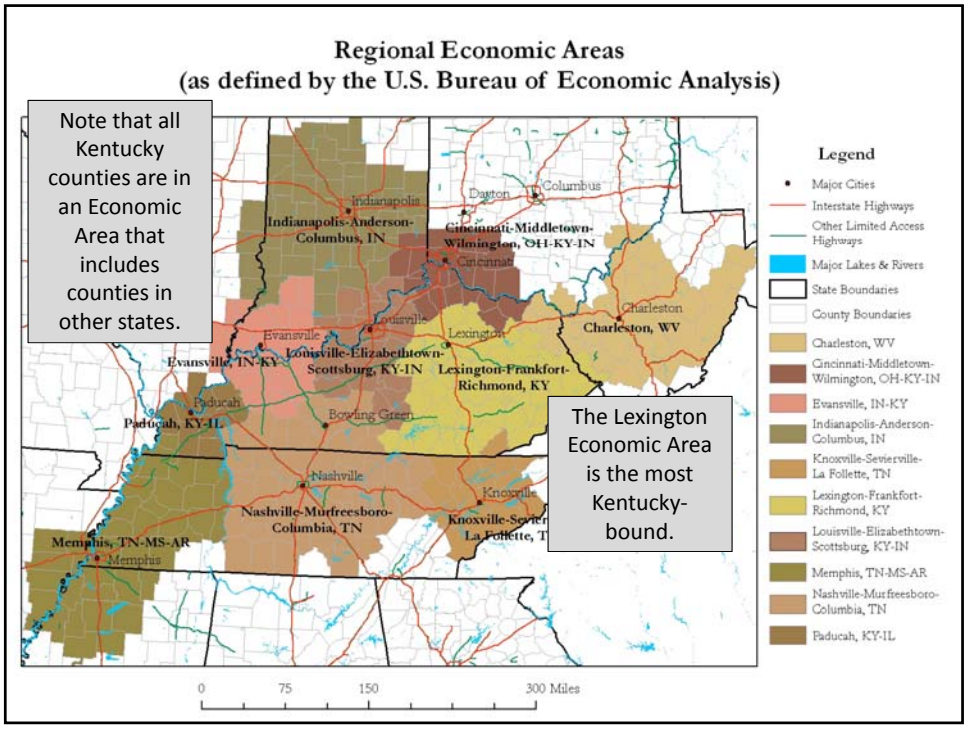
UNIVERSITY OF LOUISVILLE
COLLEGE OF BUSINESS

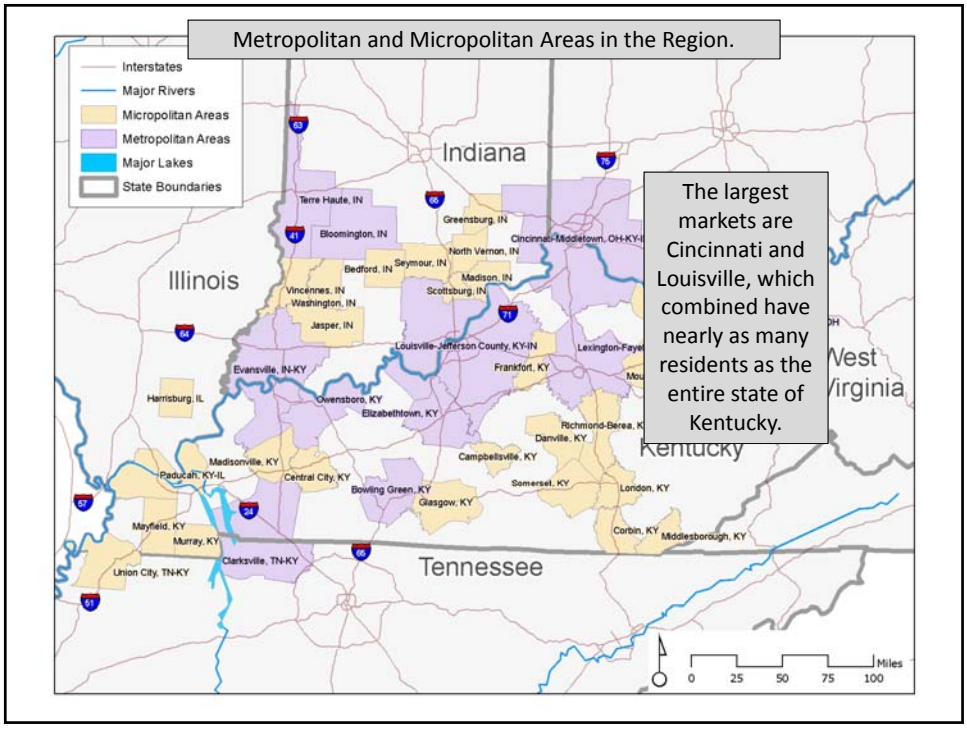
Economic Geography and Fiscal Implications

- Kentucky borders 7 states, only Tennessee and Missouri have as many border states.
- 2.4 million of Kentucky's 4.3 million residents live in a county bordering another state.
- 43 percent of Kentucky's population lives on the northern border. Daily interaction most pronounced with Indiana and Ohio.
- The *tax base* is even more geographically concentrated than the population: 42 percent of the private sector jobs in Kentucky are located in just four counties – Jefferson, Fayette, Boone, Kenton.
- Hence, Kentucky cannot set tax and spending policies in a vacuum. When there are major cross-border differences in tax rates or government spending programs, businesses and households respond by changing their places of shopping, investment, and even their residence.

Population of Kentucky Border Counties, 2010 Census

along northern border (Ohio River) with WV, OH, IN, IL		along border with WV, VA, TN, MO	
Jefferson	741,096	Christian	73,955
Kenton	159,720	Pike	65,024
Boone	118,811	Calloway	37,191
Hardin	105,543	Graves	37,121
Daviess	96,656	Whitley	35,637
Campbell	90,336	Harlan	29,278
Bullitt	74,319	Bell	28,691
McCracken	65,565	Logan	26,835
Oldham	60,316	Letcher	24,519
Boyd	49,542	Wayne	20,813
Henderson	46,250	Allen	19,956
Greenup	36,910	McCreary	18,306
Meade	28,602	Simpson	17,327
Breckinridge	20,059	Lawrence	15,860
Mason	17,490	Trigg	14,339
Spencer	17,061	Martin	12,929
Henry	15,416	Todd	12,460
Union	15,007	Monroe	10,963
Pendleton	14,877	Clinton	10,272
Lewis	13,870	Ballard	8,249
Carroll	10,811	Cumberland	6,856
McLean	9,531	Fulton	6,813
Livingston	9,519	Carlisle	5,104
Crittenden	9,315	Hickman	4,902
Trimble	8,809		
Gallatin	8,589		
Hancock	8,565		
Bracken	8,488		
subtotal	1,861,073		543,400
share of state total	42.9%		12.5%
State total	**4,339,367**		


Regional Economic Areas
(as defined by the U.S. Bureau of Economic Analysis)
Note that all Kentucky counties are in an Economic Area that includes counties in other states.
The Lexington Economic Area is the most Kentucky-bound.
Indianapolis-Anderson-Columbus, IN
Cincinnati-Middletown-Wilmington, OH-KY-IN
Evansville, IN-KY
Louisville-Elizabethtown-Scottsburg, KY-IN
Lexington-Frankfort-Richmond, KY
Charleston, WV
Paducah, KY-IL
Nashville-Murfreesboro-Columbia, TN
Memphis, TN-MS-AR
Legend
Major Cities
Interstate Highways
Other Limited Access Highways
Major Lakes & Rivers
State Boundaries
County Boundaries
Charleston, WV
Cincinnati-Middletown-Wilmington, OH-KY-IN
Evansville, IN-KY
Indianapolis-Anderson-Columbus, IN
Knoxville-Sevierville-La Follette, TN
Lexington-Frankfort-Richmond, KY
Louisville-Elizabethtown-Scottsburg, KY-IN
Memphis, TN-MS-AR
Nashville-Murfreesboro-Columbia, TN
Paducah, KY-IL
0
75
150
300 Miles


Metropolitan and Micropolitan Areas in the Region.
The largest markets are Cincinnati and Louisville, which combined have nearly as many residents as the entire state of Kentucky.
Interstates
Major Rivers
Micropolitan Areas
Metropolitan Areas
Major Lakes
State Boundaries
Indiana
Illinois
Kentucky
Tennessee
West Virginia
Terre Haute, IN
Bloomington, IN
Greensburg, IN
Cincinnati-Middletown, OH-KY-IN
North Vernon, IN
Seymour, IN
Bedford, IN
Madison, IN
Scottsburg, IN
Vincennes, IN
Washington, IN
Jasper, IN
Louisville-Jefferson County, KY-IN
Lexington-Fayette
Frankfort, KY
Evansville, IN-KY
Harrisburg, IL
Owensboro, KY
Elizabethtown, KY
Richmond-Berea, KY
Danville, KY
Campbellsville, KY
Madisonville, KY
Paducah, KY-IL
Central City, KY
Bowling Green, KY
Glasgow, KY
Somerset, KY
London, KY
Mayfield, KY
Murray, KY
Clarksville, TN-KY
Union City, TN-KY
Corbin, KY
Middlesborough, KY
0
25
50
75
100
Miles

Location of Private Sector Jobs in Kentucky

Top 10 Counties, Private Sector Jobs in 2010

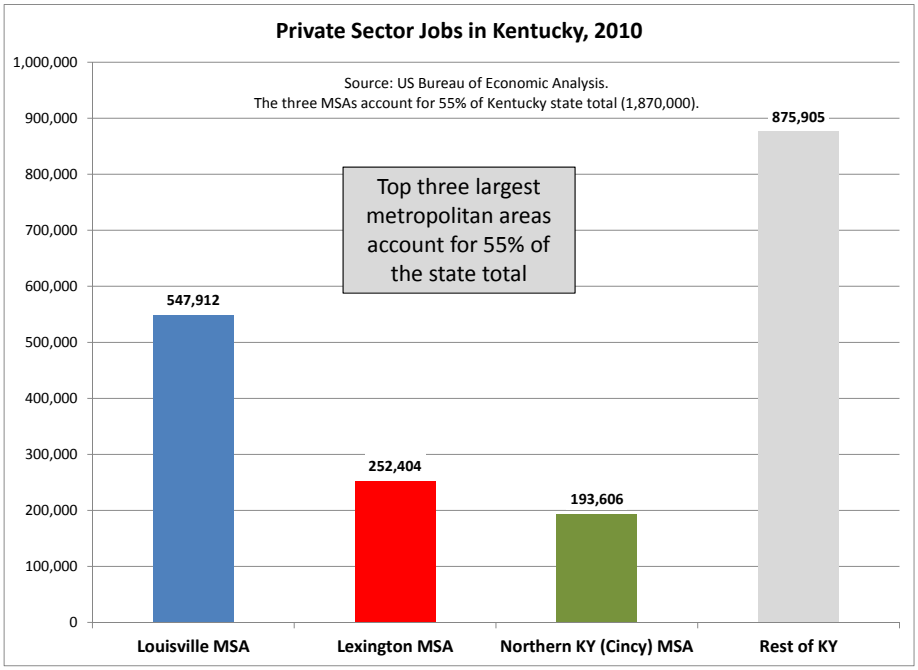
Counties	Private Jobs	Share of State
Jefferson	462,114	24.7%
Fayette	171,201	9.2%
Boone	80,784	4.3%
Kenton	68,569	3.7%
Warren	56,500	3.0%
Daviess	44,689	2.4%
McCracken	41,104	2.2%
Hardin	40,587	2.2%
Campbell	31,789	1.7%
Madison	30,094	1.6%
Rest of KY	842,396	45.1%
Kentucky	1,869,827	100.0%

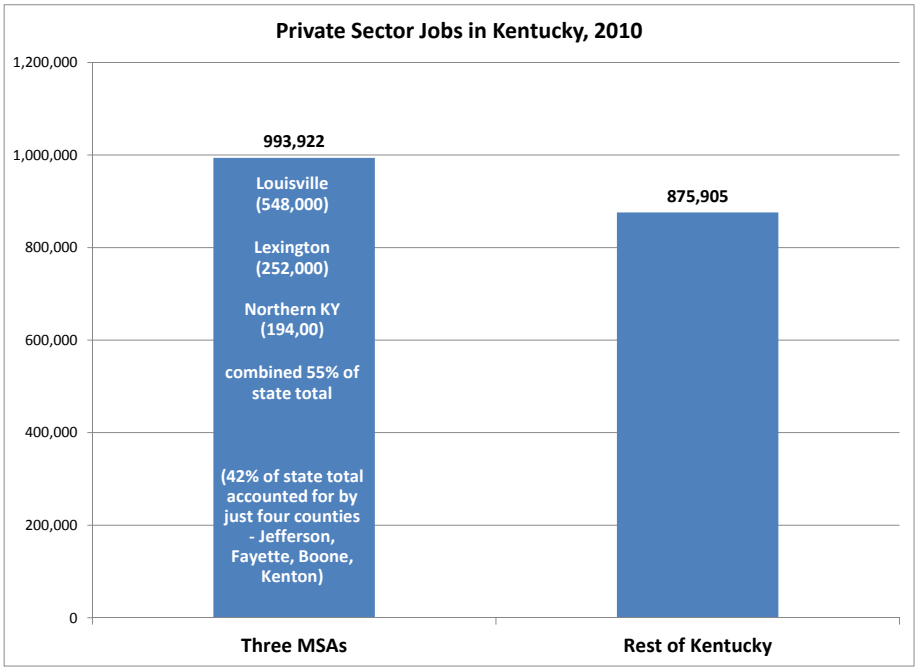
Top four counties contain 42% of state total

Top 10 Counties, Growth in Private Sector Jobs 2001-2010

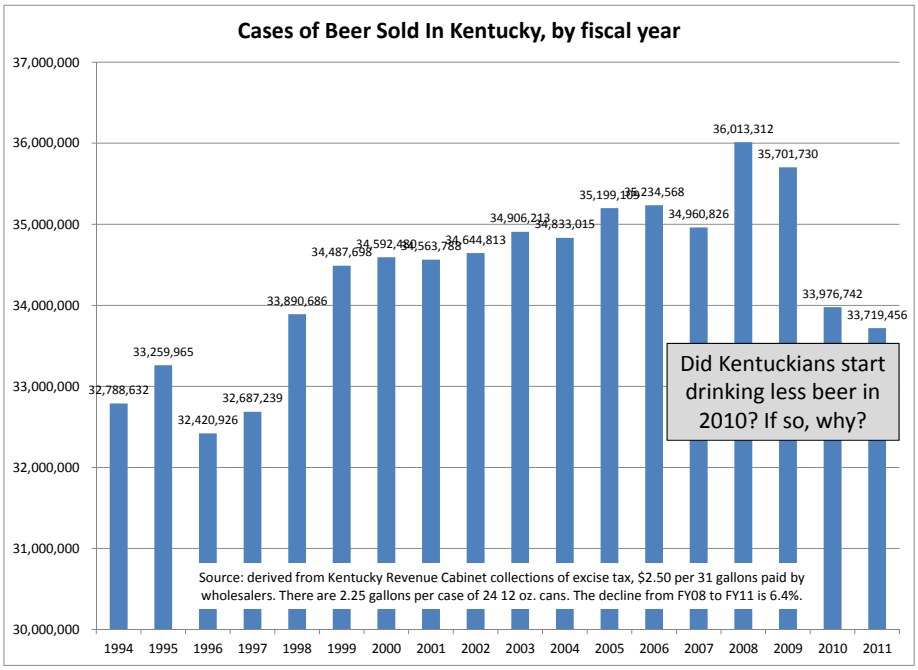
Counties	Growth	Percent	Ranking, percent
Warren	7,530	15.2%	13
Kenton	6,898	11.2%	20
Bullitt	6,875	40.9%	2
Fayette	5,674	3.4%	51
Boone	4,949	6.5%	39
Hardin	3,945		22
Campbell	3,023		24
Marshall	2,862		27
Oldham	2,840		5
Jessamine	2,712		9
Rest of KY	-2,107		
Kentucky state total	45,201	2.5%	

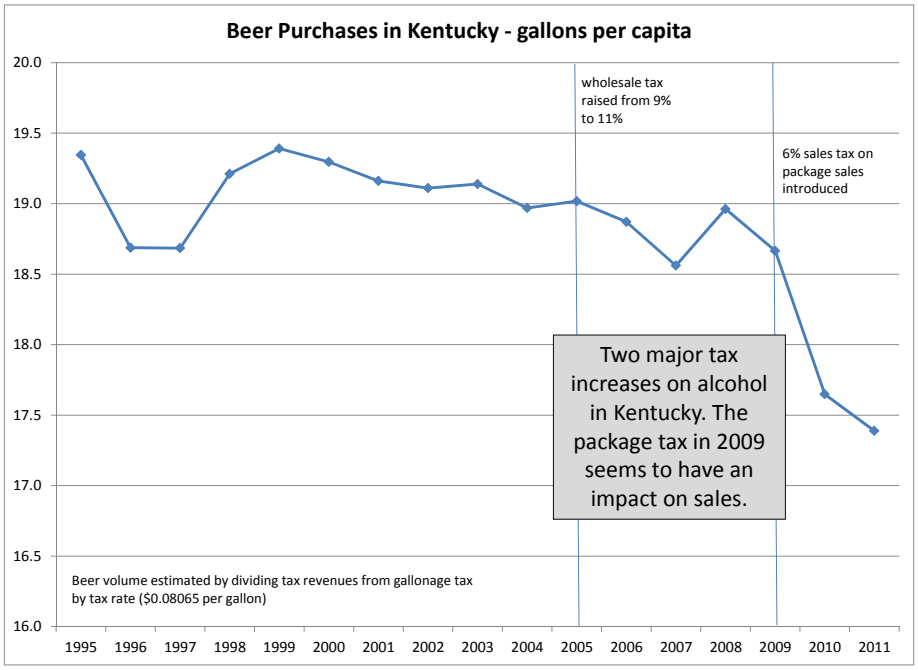
Top ten counties accounted for all the net growth statewide this decade

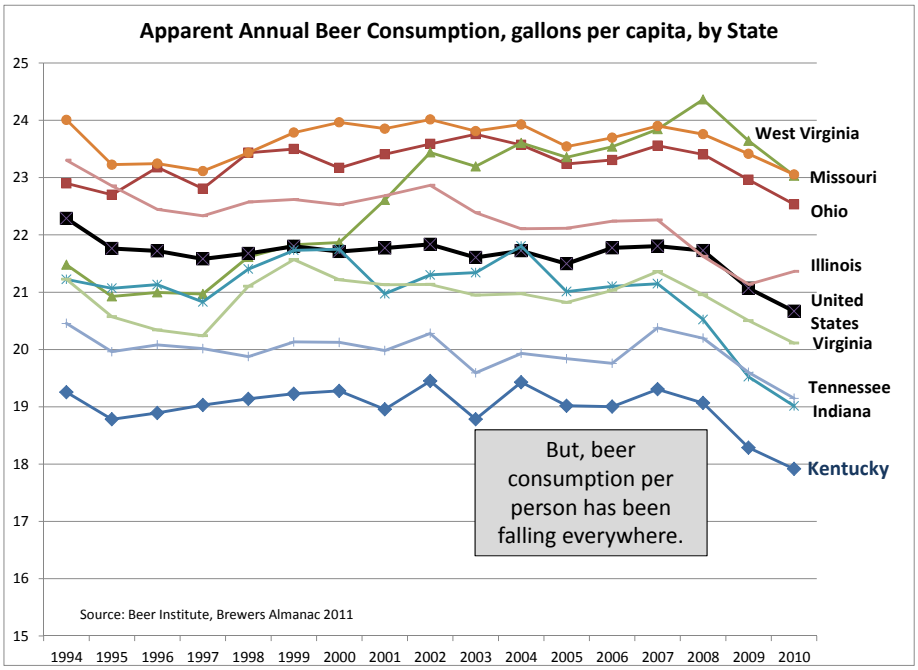


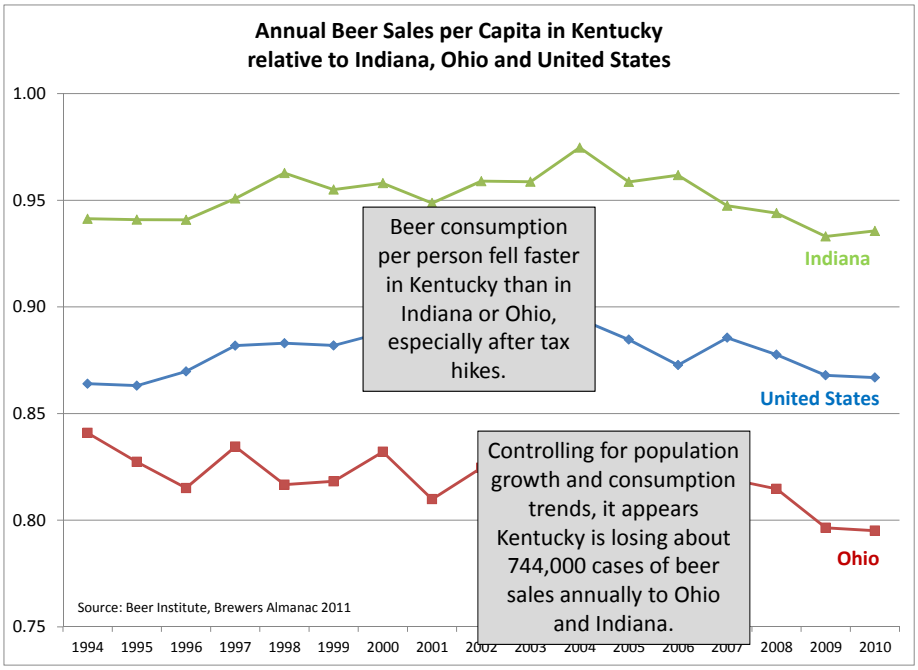


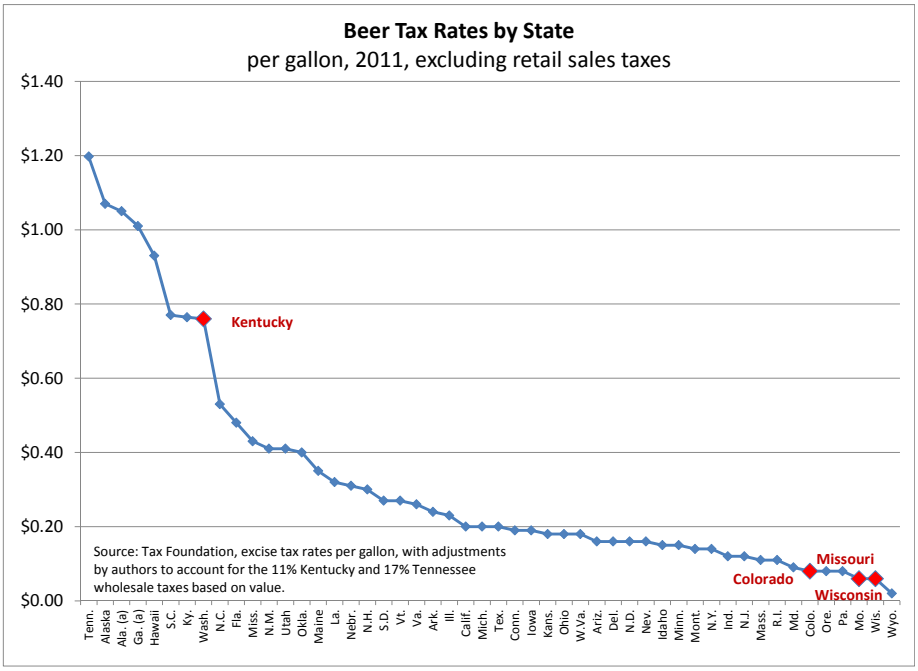
Example of Cross Border Competition: Beer Taxation

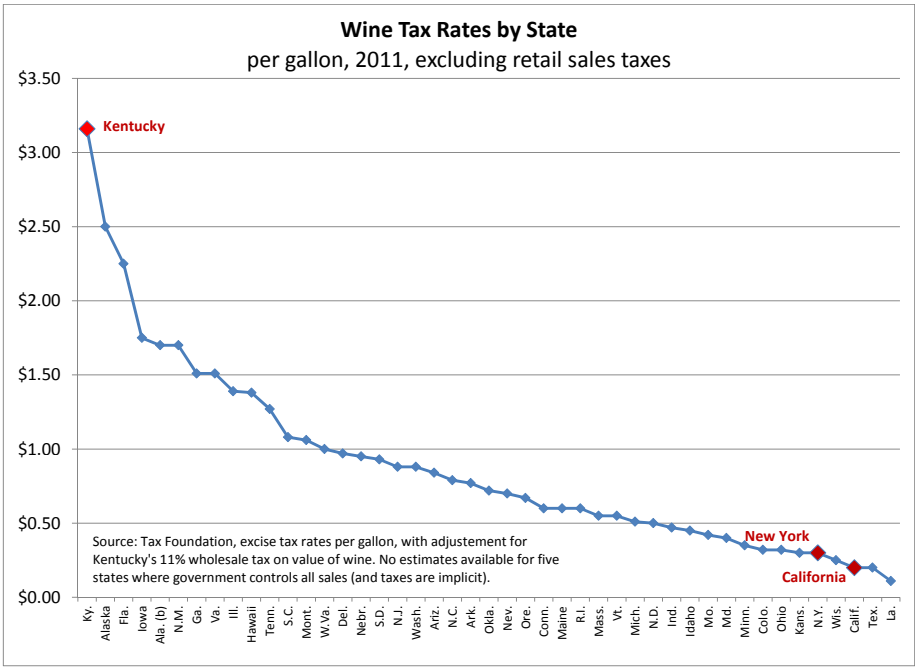

Cases of Beer Sold In Kentucky, by fiscal year
37,000,000
36,000,000
35,000,000
34,000,000
33,000,000
32,000,000
31,000,000
30,000,000
32,788,632
33,259,965
32,420,926
32,687,239
33,890,686
34,487,698
34,592,480
34,563,788
34,644,813
34,906,213
34,833,015
35,199,185
35,234,568
34,960,826
36,013,312
35,701,730
33,976,742
33,719,456
Did Kentuckians start drinking less beer in 2010? If so, why?
Source: derived from Kentucky Revenue Cabinet collections of excise tax, $2.50 per 31 gallons paid by wholesalers. There are 2.25 gallons per case of 24 12 oz. cans. The decline from FY08 to FY11 is 6.4%.
1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011

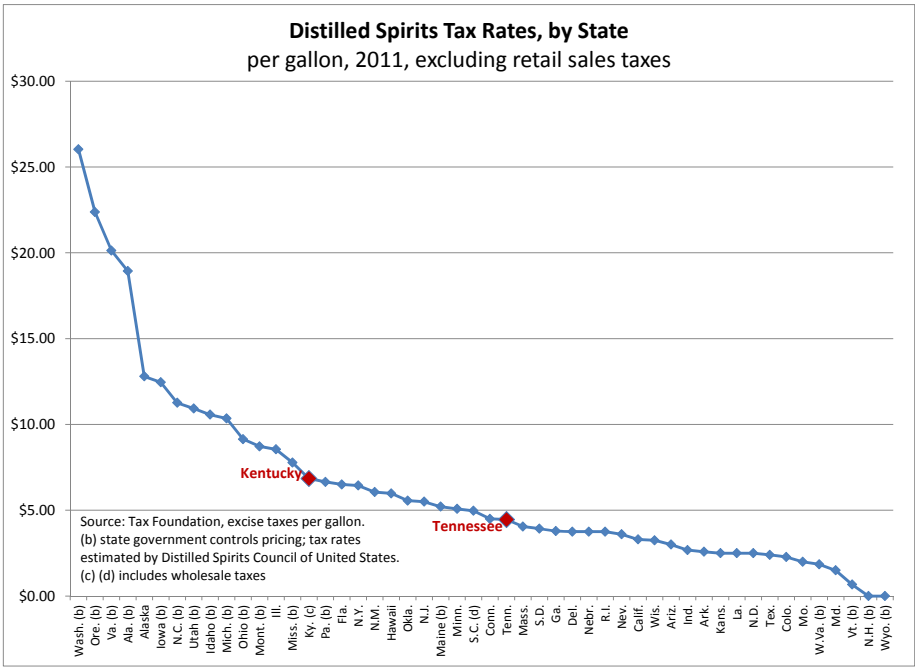

Beer Purchases in Kentucky - gallons per capita
20.0
19.5
19.0
18.5
18.0
17.5
17.0
16.5
16.0
wholesale tax raised from 9% to 11%
6% sales tax on package sales introduced
Two major tax increases on alcohol in Kentucky. The package tax in 2009 seems to have an impact on sales.
Beer volume estimated by dividing tax revenues from gallonage tax by tax rate ($0.08065 per gallon)
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011


Apparent Annual Beer Consumption, gallons per capita, by State
25
24
23
22
21
20
19
18
17
16
15
1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
West Virginia
Missouri
Ohio
Illinois
United States
Virginia
Tennessee
Indiana
Kentucky
But, beer consumption per person has been falling everywhere.
Source: Beer Institute, Brewers Almanac 2011


Annual Beer Sales per Capita in Kentucky relative to Indiana, Ohio and United States
1.00
0.95
0.90
0.85
0.80
0.75
1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Indiana
United States
Ohio
Beer consumption per person fell faster in Kentucky than in Indiana or Ohio, especially after tax hikes.
Controlling for population growth and consumption trends, it appears Kentucky is losing about 744,000 cases of beer sales annually to Ohio and Indiana.
Source: Beer Institute, Brewers Almanac 2011

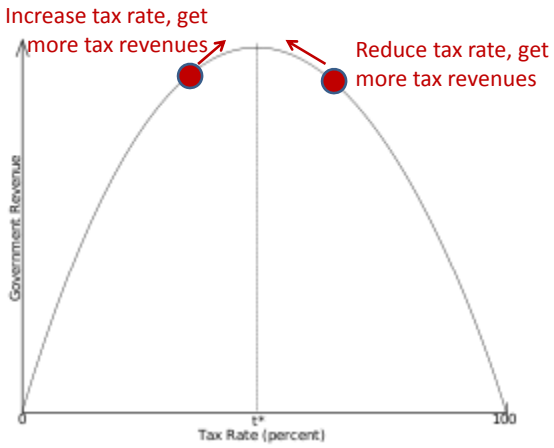

Beer Tax Rates by State
per gallon, 2011, excluding retail sales taxes
$1.40
$1.20
$1.00
$0.80
$0.60
$0.40
$0.20
$0.00
Kentucky
Missouri
Colorado
Wisconsin
Source: Tax Foundation, excise tax rates per gallon, with adjustments by authors to account for the 11% Kentucky and 17% Tennessee wholesale taxes based on value.
Tenn. Alaska Ala. (a) Ga. (a) Hawaii S.C. Ky. Wash. N.C. Fla. Miss. N.M. Utah Okla. Maine La. Nebr. N.H. S.D. Vt. Va. Ark. Ill. Calif. Mich. Tex. Conn. Iowa Kans. Ohio W.Va. Ariz. Del. N.D. Nev. Idaho Minn. Mont. N.Y. Ind. N.J. Mass. R.I. Md. Colo. Ore. Pa. Mo. Wis. Wyo.


Wine Tax Rates by State
per gallon, 2011, excluding retail sales taxes
$3.50
$3.00
$2.50
$2.00
$1.50
$1.00
$0.50
$0.00
Kentucky
New York
California
Source: Tax Foundation, excise tax rates per gallon, with adjustement for Kentucky's 11% wholesale tax on value of wine. No estimates available for five states where government controls all sales (and taxes are implicit).
Ky. Alaska Fla. Iowa Ala. (b) N.M. Ga. Va. Ill. Hawaii Tenn. S.C. Mont. W.Va. Del. Nebr. S.D. N.J. Wash. Ariz. N.C. Ark. Okla. Nev. Ore. Conn. Maine R.I. Mass. Vt. Mich. N.D. Ind. Idaho Mo. Md. Minn. Colo. Ohio Kans. N.Y. Wis. Calif. Tex. La.

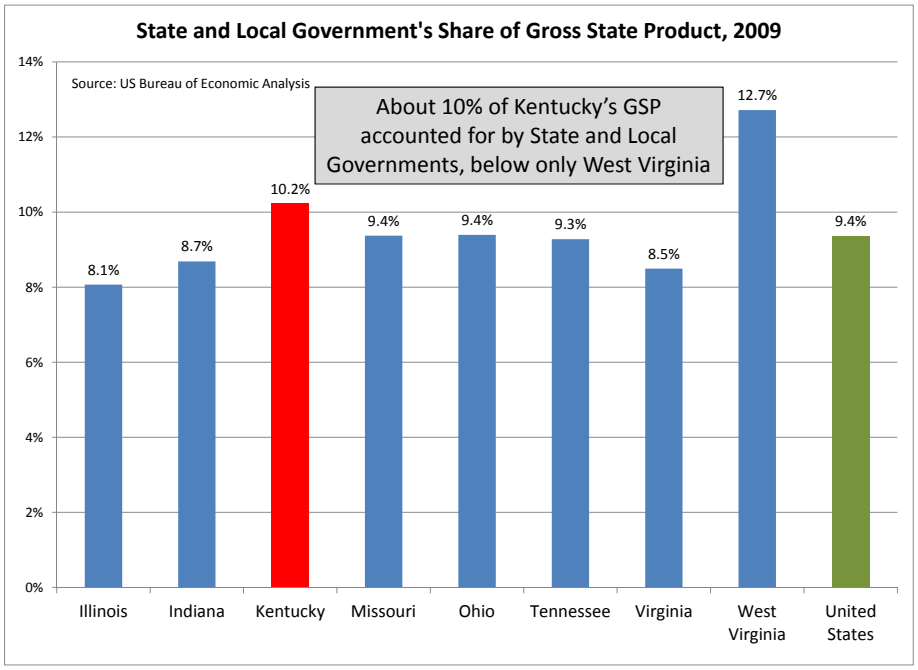


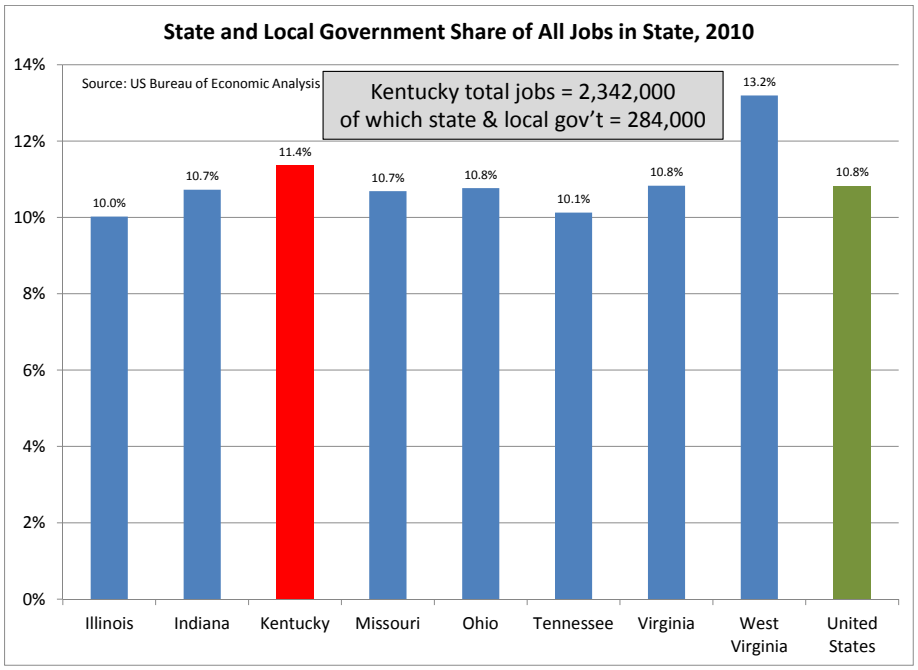
Tax Policy Issue

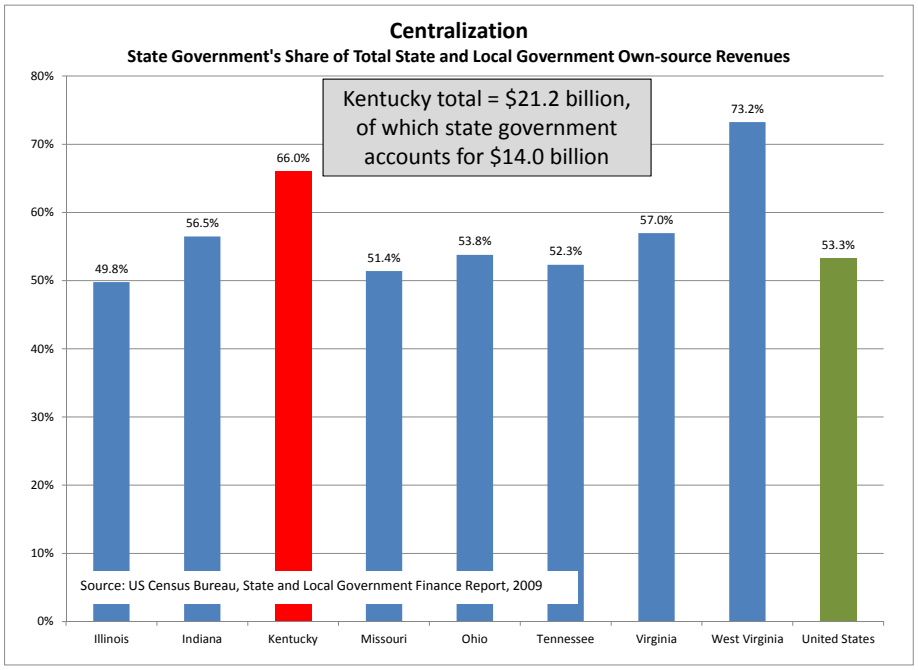
Are we past the inflection point of the Laffer Curve?



High-level state comparisons
of government size, revenues, and expenditures




State and Local Government Share of All Jobs in State, 2010
Source: US Bureau of Economic Analysis
Kentucky total jobs = 2,342,000
of which state & local gov't = 284,000
14%
12%
10%
8%
6%
4%
2%
0%
10.0%
10.7%
11.4%
10.7%
10.8%
10.1%
10.8%
13.2%
10.8%
Illinois
Indiana
Kentucky
Missouri
Ohio
Tennessee
Virginia
West Virginia
United States


Centralization
State Government's Share of Total State and Local Government Own-source Revenues
Kentucky total = $21.2 billion,
of which state government
accounts for $14.0 billion
Source: US Census Bureau, State and Local Government Finance Report, 2009
80%
70%
60%
50%
40%
30%
20%
10%
0%
49.8%
56.5%
66.0%
51.4%
53.8%
52.3%
57.0%
73.2%
53.3%
Illinois
Indiana
Kentucky
Missouri
Ohio
Tennessee
Virginia
West Virginia
United States

Before the
The Governor's Blue Ribbon Commission
On Tax Reform

Gross Receipts Taxes
an overview

By
Robert L. Salyer
Northern Kentucky University

My name is Robert Salyer. I am an Instructor at Haile/US Bank College of Business at Northern Kentucky University. I am also the Director of the Master of Accountancy program. My teaching area is taxation. Although I have been in education for the last ten years the majority of my career has been in the private sector as both a practicing certified public accountant and a tax manager in industry concentrating in taxation.

My comments today will focus on a recent trend in state and local taxation – the gross receipts or gross margin tax. Several states have moved to this tax model in an attempt to protect the tax base from fluctuations in business profits.

Overview

I begin my undergraduate class with an explanation that every tax has a tax base and a tax rate. The Gross Receipts tax reflects one of the simplest forms of taxation. Total Revenue is the tax base and it is multiplied by a tax rate.

Gross receipts taxes have been attractive to states as they offer an easily defined tax base. Often the tax base can be projected based upon historical sales tax reporting. Some states have found that a tax base using total revenue is more stable than one based upon net income. In an effort to balance state budgets some have found the gross receipts tax to be a solution.

Gross receipts taxes have been used to provide tax relief for domestic (in-state) taxpayers. Some states have reduced real estate and income taxes and replaced those taxes with the gross receipts tax.

Gross receipts taxes have met with opposition as taxpayers in different industries bear disproportionate tax burdens. Manufactures typically favor the gross receipts model as they have relatively high gross profit (markup) in relation to revenue. Retailers are opposed to the gross receipts taxes as they generally have lower gross profits. In efforts to mitigate this effect some states including Kentucky have an alternative computation bases upon gross profit. Although this addresses the problem is ads complexity as statutes and regulations must proscribe the computation of cost of sales.

Federal law limits the ability of states to impose sales taxes on out of state taxpayers. Gross receipts taxes are not sales taxes and therefore allow states to impose tax on out of state businesses which sell in the jurisdiction. The ability to have jurisdiction and assert a tax is referred to as nexus. Generally nexus requires a physical presence. Gross receipts taxes impose a concept referred to as economic nexus. Essentially if a taxpayer is selling to residents of a state or providing services to residents of that state they are subject to the tax. I have included an example of Ohio's application of that concept latter in this presentation.

Some criticize the gross receipts tax as being burdensome to taxpayers as it ignores profitability. Others believe the tax bears no relation to economic activity (employment, investment in plant, property and equipment) within a state.

Substantial criticism of gross receipts taxes comes from a characteristic known as pyramiding. Gross receipts taxes create an extra layer of taxation at each state of production.[1] Every purchase of a component is subject to the tax. Sales taxes are imposed only upon the final consumer thus one level of tax. Value added taxes provide a mechanism to tax only the incremental sales value at each step.

Chamberlain and Fleenor explained pyramiding[2];

> Gross receipts taxes have a simple structure, taxing all business sales with few or no deductions. Because they tax transactions, they are often compared with retail sales taxes. However, they differ in a critical way. Well-designed sales taxes apply only to final sales to consumers, but gross receipts taxes tax all transactions, including intermediate business-to-business purchases of supplies, raw materials, and equipment. As a result, gross receipts taxes create an extra layer of taxation at each stage of production that sales and other taxes do not -- what economists call "tax pyramiding."
>
> Under a gross receipts tax, every item that changes hands between companies is taxed, regardless of whether it is a final product or raw material. As a result, in industries in which products move through multiple stages of production -- from raw material to manufacturing, distribution, and so on -- the value created in early stages of production is taxed repeatedly in subsequent stages.
>
> Because gross receipts taxes result in tax pyramiding, companies have powerful incentives to cut the number of production stages for products by absorbing suppliers. By consolidating into larger firms with fewer taxable business-to-business transactions, industries can lower their effective tax burdens under gross receipts taxes. That consolidation of previously separate companies is known as vertical integration.
>
> On the importing side, gross receipts taxes have an inherent tendency to favor imported goods over domestically produced products. The reason is simple: imports from states without gross receipts taxes pass through fewer taxable stages of production than goods produced domestically, particularly if they are imported as finished products. As a result, gross receipts taxes place in-state companies at a tax disadvantage to out-of-state importers not subject to gross receipts taxes.

Kentucky

Changes to Business taxes in Kentucky were instituted in 2005 and 2007. That effort included a gross receipts tax. Kentucky's gross receipts tax is the Limited Liability Entity Tax. Kentucky maintains an income tax with a credit given for the Limited Liability Tax. Kentucky's gross receipts tax exempts most taxpayers as it generally applies only to in-state businesses with Kentucky revenues in excess of $ 6 million. Kentucky tax is at a low rate with large exemptions and was originally designed as a minimum tax.

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[1] Tax Pyramiding: The Economic Consequences of Gross Receipts Tax, Andrew Chamberlain and Patrick Fleenor, 43 State Tax Notes 457

[2] id

As Kentucky maintains an income tax these 2005 and 2007 changes were characterized by Robert Cline the national director of state and local tax policy at Ernst & Young as attempts to shore up the existing state corporate tax base.[3]

Mr. Cline observes:

> Recent state tax legislation affecting business taxes can be divided between states enacting new business taxes as part of major tax reform packages and states that are attempting to preserve and expand their existing tax bases. While fiscal pressures are driving some states to increase overall corporate income taxes, economic development concerns are simultaneously pushing states to shift taxes increasingly to out-of-state firms. Those opposing forces produce combinations of tax changes, including the disallowance of subtractions for payments to affiliated nontaxpayers, increased use of targeted tax incentives for in-state economic activity, and the adoption of 100 percent sales apportionment formulas for the corporate income tax.[4]

Recent implementations of the Gross Receipts Tax

These recent efforts[5] began in 2002 New Jersey initiated a movement to abandon the traditional corporate income tax in an effort to maintain corporate tax collections despite a decrease in profits (income tax collection) due to the recession. New Jersey implemented a gross receipts or gross margin tax which sunsetted in 2006.[6]

Major tax reforms were enacted in Ohio (2005), Texas (2006), and Michigan (2007). Those reforms enacted new broad-based taxes to replace existing business taxes and to reduce business property taxes. Each of those reforms was designed to make the states' companies more competitive while making important structural changes in business taxes. The new tax bases are much broader than the corporate net income tax base; they have lower tax rates, extend to noncorporate businesses, and apply to out-of-state businesses selling goods and services into the state. All three states use 100 percent destination sales factor apportionment formulas to determine the share of the U.S. tax base taxable in a state.[7]

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[3] Future State Business Tax Reforms: Defend or Replace the Tax Base, Robert Cline Thomas Neubig, 47 State Tax Notes 179 (Jan. 21, 2008)

[4] Id p.182

[5] Professor John L. Mikesell of Indiana University examines the history of the gross receipts tax in Europe and the United State in "State Gross Receipts Taxes And the Fundamental Principles of Tax Policy" 43 State Tax Notes 615. In that report Professor Mikesell summarizes earlier implementations in Germany 1918, France 1920, Austria, Belgium, Italy, Luxembourg and Spain all repealed in the 1960s. European countries generally replace the gross receipts tax with a value added tax. In the United States gross receipts taxes are or have been in, Alaska repealed in 1979, Delaware in effect, Georgia 1929 to 1931, Indiana 1933 to 1963, New Jersey 2002 to 2006 expired, West Virginia 1921 to 1986, Mississippi 1930 to 1932, and Washington in force.

[6] Id note 5

[7] Future State Business Tax Reforms: Defend or Replace the Tax Base, Robert Cline Thomas Neubig, 47 State Tax Notes 179 (Jan. 21, 2008)

Ohio

Ohio's 2005 reform package was designed to reduce total taxes by $3.3 billion annually. The package includes a $1.4 billion reduction in business taxes, primarily from the phase-out of business tangible personal property taxes. For most business taxpayers, the tax reforms eliminate the corporate income tax and business personal property taxes and adopt a new business tax, a 0.26 percent commercial activity tax (CAT). The CAT is a gross receipts tax with some subtractions for intercompany sales with affiliated companies.

By eliminating the tangible personal property tax on business Ohio, reduced the tax burden on those companies with a physical presence in Ohio.

The Ohio tax reaches taxpayers who were previously not subject to taxation in Ohio. Traditionally, services have been taxed by the state where the service is preformed. Ohio contends that services should be taxed to the location where the benefit of services is received. For example, legal services are sitused to Ohio if those services relate to Ohio regardless of where the services are performed. Accordingly, if an attorney drafts a will in Kentucky for a client who resides in Ohio, the gross receipts from that service will be sitused (taxed) by Ohio since the services relate to an Ohio estate.[8]

The State Supreme Court of Ohio rejected a state constitutionality challenge however; some continue to argue that the Ohio law is contrary to previous U.S Supreme Court decisions.[9]

Michigan

In 2007 Michigan replaced the single business tax (a modified value added tax) with the Michigan business tax (MBT). The MBT applies to corporate and noncorporate taxpayers and consisted of two separate taxes: a modified gross receipts tax at a .08 percent rate with a deduction for purchases of tangible personal property and a business income tax at a 4.95 percent tax rate. Taxpayers paid both taxes.

The gross receipts tax was projected to generate two-thirds of the new business-entity taxes before credits. The Michigan reform package reduced business property taxes by $600 million annually through credits and rate reductions and provided an additional $1 billion in targeted tax credits for investment, compensation, and R&D spending in Michigan. Overall, the business tax reform package was designed to be revenue neutral. [10]

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[8] What the CAT Dragged In: The Tax Outside Ohio's Borders, Thomas H. Steele, 58 State Tax Notes 107

[9] The Ohio Commercial Activities Tax: Why Out-of-State businesses Should Sit Up and Take Notice, Laura A. Kulwicki, 41 State Tax Notes 113

[10] Id pp 182 - 183

Tax reform fails in Michigan

In May of 2011 Michigan Governor Rick Snyder signed a new law replacing the Michigan business tax with a 6 percent corporate income tax.[11] The gross receipts tax lasted only four years. In the end, the prior tax was repealed and the MBT was enacted (followed by a 22 percent MBT surcharge and a $765 million personal income tax hike later in the year when legislators realized that the numbers just didn't add up).[12]

Perhaps the failure was due to acting in haste. Michigan's previous tax was a modified value added tax. The tax was complex and compliance was costly and difficult. The gross receipts tax offered simplicity and a broad tax base. However in the end it did not generate the revenue needed.

Texas

Texas in 2006 enacted a $2.5 billion tax cut for individuals, with a revenue-neutral change in business taxes. The new Texas business tax, the so-called margin tax, will raise $6 billion annually to pay for a $3.4 billion reduction in business property taxes and a $2.5 billion elimination of the Texas franchise tax. The new business tax gives companies a choice of three tax base options:

1) 70 percent of gross receipts; 2) gross receipts less cost of goods sold; or 3) gross receipts less compensation.

When it was enacted in 2006, the tax was estimated to raise about $6 billion a year and was a major component of a tax swap plan under which the state would assume a larger share of public school costs, allowing a reduction in school district property taxes. The tax was first collected in 2008 and has never produced more than $4.8 billion a year.

The Texas tax is levied on a form of modified gross receipts allowing for a deduction for cost of goods sold. Given the sluggish economy some Texas officials don't believe the tax has been in effect long enough to say whether it's a fair, stable revenue source for the state or not.

Lieutenant Governor Dewhurst observed he wouldn't trade the state's current fiscal problems for a tax system based on an income tax. "I think the recession has shown the problem with relying heavily on an income tax," Dewhurst said. "When the economy is strong, it zooms up like an F-18 fighter. Then, when the economy cools, states with income taxes like California and New York have their work cut out for them because revenues drop just as fast as they went up." [13]

---

[11] Michigan Governor Signs Corporate Income Tax Bill, 60 State Tax Notes 615 (May 30, 2011)
[12] Michigan Business Taxes on the Rocks, Marjorie Gell 59 State Tax Notes 803 (Mar. 14, 2011)
[13] State Tax Merry-Go-Round, 57 State Tax Notes 317 (Aug. 2010)

Ohio

Ohio's Commercial Activity Tax rate is .0026. All companies with taxable gross receipts above $1 million are required to pay the CAT. Gross receipts are the "total amount realized without deduction for the cost of goods sold or other expenses. That includes the performance of services, sales, and rentals or leases.[14]

In contrast, Kentucky's Limited Liability tax rate on gross receipts is .00095 and the tax rate on gross profit is .0075. Kentucky tax is fully implemented when gross receipts from all sources exceed $ 6 million and is phased in for multi-state companies starting at $ 3 million.

According to the Ohio Department of Taxation, the Commercial Activity Tax is considered "a tax on the privilege of doing business in Ohio, measured by gross receipts received in an annual or calendar quarter time period." It is not considered to be a transactional sales tax. The CAT applies to all kinds of businesses, including retailers, manufacturers, and service providers, such as lawyers, accountants, and doctors. The CAT also applies to out-of-state businesses.[15]

Business supported the Ohio CAT Tax

The Ohio Business Roundtable (a nonpartisan organization composed of the chief executive officers of the state's largest businesses) also argued strongly in favor of the creation of the CAT. One reason for the group's support was its belief that the CAT would spread the business tax burden throughout all sectors of the economy because the tax would be applied to anyone with gross receipts over $1 million. The Roundtable argued that the corporate franchise tax unfairly overburdened the manufacturing and retail sectors of the economy. The Roundtable also argued that, unlike the corporate franchise tax, the CAT would be almost impossible to avoid. According to the Roundtable, this would make the system more equitable and all businesses, no matter what their size, would have to pay their fair share of taxes.

Business opposed the Ohio CAT Tax

The Ohio Chamber of Commerce strongly opposed it. First, the chamber was concerned that the CAT would automatically increase a company's tax liability for every dollar increase in sales. The chamber also thought the new tax would adversely affect business-to-business sales and raise prices at all points during the manufacturing supply chain. The chamber was concerned that the CAT would harm new businesses and businesses that are not profitable. A company would be taxed on all sales, even if they were not making a profit. Furthermore, the chamber believed that the tax would have a particularly negative effect during recessions.

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[14] Examining Ohio's Commercial Activity Tax, Brian Sigritz, 39 State Tax Notes 567 (Feb 20,2006)
[15] id

To illustrate its point about the harmfulness of the CAT, the chamber discussed the history of gross receipts taxes in other states. According to the chamber, Indiana repealed its gross receipts tax in 2002, West Virginia and Minnesota repealed theirs nearly 20 years ago, and the tax remains unpopular in both New Jersey and Washington.[16]

Analysis of the Ohio CAT Tax

Ernst & Young in conjunction with the Council on State Taxation publishes a state-by-state comparison of the tax liabilities that new investments in selected industries or types of economic activities incur in each state, taking into consideration state and local statutory tax provisions and the financial and economic characteristics of the new investments.

A report was prepared for the Ohio Business Roundtable based upon the state by state report. The report is said to measure the competitiveness analysis including business tax burdens for all major state and local taxes imposed on business activities associated with ***new capital investments***. *(Emphasis added)*[17]

Based upon that analysis Ernst & Young found that:

As a result of tax reform, *Ohio jumped from the 31st most competitive state and local business tax system in 2004 to the 3rd most competitive in the nation in 2009* for these types of investments. The same study found Kentucky has moved from 17th to 15th most competitive in the nation.[18] The measure the supporters of the CAT tax chose was new capital investment. This did not measure the business climate for existing taxpayers.

In 2009 after the CAT tax became fully effective Policy Matters Ohio found that Revenue was 7.4 percent below projections. Policy matters Ohio concluded that the CAT is not holding up in the poor economy.

Recently Policy Matters Ohio stated "We suggest reinstating the corporate franchise tax without the loopholes that plagued it, at a low rate, and corporations could then pay either the higher of the CAT or the Corporate Franchise Tax. Some very large Ohio firms pay little or no CAT tax because their sales are primarily or all out of state. Reinstatement of the Corporate Franchise Tax would ensure all Ohio's corporate citizens get to participate in paying their fair share." [19]

Professor John Mikesell of Indiana University had the following observations on the gross receipts taxes:[20]

> ***Broad base***. The gross receipts tax base is broad, considerably broader than the economy of the government that levies the tax. However, breadth itself is not an appropriate standard for evaluating a tax as a revenue source. That broad base is not logical as an indicator of either capacity to bear the cost of government or consumption of government services.

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[16] id

[17] Analysis of Changes in Ohio's Business Tax Competitiveness: 2004 vs. 2009, Prepared for the Ohio Business Roundtable, August 22, 2011

[18] id

[19] Testimony of Wendy Patton, Senior Associate, Policy Matters Ohio, Before the Senate Finance Committee, Prepared for delivery on May 19, 2011

[20] State Gross Receipts Taxes and the Fundamental Principles of Tax Policy, John L. Mikesell, 43 State Tax Notes 615

Low rate. Statutory gross receipts tax rates may be low, but they are not necessarily so. Whether the legal rate is relatively high or low depends on how much revenue the government intends to raise. Even with its broad base, a low rate on gross receipts is unlikely to contribute a major share of revenue to a modern state government. Low-rate, low-yield taxes also often have high administrative and compliance cost relative to the amount of revenue generated.

Stable revenue. A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not contribute to the overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

Economic Neutrality. A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. In particular, it establishes artificial incentive for vertical integration and discriminates against business contracting and the advantages of scale and specialization that production by independent firms can bring.

Competitiveness. A gross receipts tax interferes with the capacity of individuals and business to compete with those in other states and other parts of the world. The tax embedded in prices grows as the in-state component of the production chain is greater, so there is incentive to purchase business inputs from outside the state. And businesses must deal with the embedded gross receipts tax when it seeks to make sales to out of state customers. Possibly most significantly, the tax discourages capital investment by adding to the cost of factories, machinery, equipment, and so forth, with the extent of disincentive dependent on how much of those capital goods are produced in the state. That tax structure is not good strategy for growth and development of the state.

Fairness. A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage in comparison with higher-margin firms, no matter what their overall profitability might be. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chances that these firms will survive. That also is not consistent with a climate for growth and development.

Transparency. A gross receipts tax is a stealth tax, with its true burden concealed from the public. The public does not see the tax because it is legally imposed on businesses and they have no way of seeing the effect of pyramiding that converts a low legal rate into a much higher effective rate. Hiding the cost of government is not a way to get efficient and responsive provision of government services and is entirely contrary to the fundamentals of democratic government.

Conclusion

Kentucky has a gross receipts tax in place. The tax base is defined. Kentucky's tax base differentiates between taxpayers with high and low profit margins as it offers a tax on gross receipts or gross profits. It would be very easy to move the Limited Liability Entity Tax from a secondary tax to the primary state business tax. Kentucky might follow other states in offering tax relief to those with substantial employment and investment in property.

As one who has spent many years in tax practice and compliance, the simplicity of a gross receipts tax is appealing.

On the other hand a tax that does not consider the profitability, competitiveness and the ability to pay gives me great concern. I would also urge the Committee to consider the lack of economic neutrality and transparency of a gross receipts tax. While the popularity of a gross receipts tax is evident with the Ohio and Texas experience the literature expresses concern on the effect on the business climate of the states which have adopted this approach.

Tax Reform Public Meeting Speakers

Bowling Green Speakers
Jim Mattingly
Rex Reid
Michelle Sanborn
Fran Carico
James Wilkerson
Patricia Tarquino
Joe Tineus
Jim Flynn
Jennifer Hawkins
Ellen Blevins
Jacob Abrahmson
Wayne Young
Lynn Dawson
Allen Smith
Steve Wells
Larry Vick
Ron Bunch
Dana Beasly Brown
Norman Harnett
Charles Harcastle
Bill Howell
Sandy Joiner
Eileen Arnold
Mr. Sloan
Robin Calamaio
Jim Duffer
James Penassi
Steve Davis/James Cook
Marshall Celsor

Paducah Transcripts
Mayor Bill Paxton
Mary Potter
Bob Hopman
Richard Heath
Wayne Elliot
Neil Archer
Nancy Broyles
Shannon Stiglitz
Marie McMillan
Ken Cook
Belinda Hutson
Steve Shannon
Larry Davis
Sheina Murphy
Amy Barkley
Jessica Carlson

Prestonsburg Transcripts
Russell Oliver
Eric Lewis
Bob Burn
John Henderson
Norman Jones
Paul David Brown
Morris Hylton
Allison Williams
Jean Rosenburg
Bud Warman
Timothy Weaver
Dip Stafford
John M. Rosenburg
Jan Whitaker
Connie Brooks
Carolyn Spartman
Wilson Sears
Dr. Wayne Andrews

Highland Heights
Laura Roberts
Becky Bargett
Louise Stidell
Don Ruberg
Mike Hammons
Brigitte Blom Ramsey
Kim Fender
Bob Hile
Emily Shelton
Lisa Gabbard
Jim Cole
Kevin Gordon
Patrick Lucas
Garth Kuneheim
Greg Cooper
Mike Ross
Larry Robinson
Todd Griffen
Debbie Simpson
Rosanne Mills
Brian Painter
Jim Huff

Lexington Transcripts
Rich Seckel
Eric Gregory
Jeff Conder
Matt Shapiro
Karl Krase
Stacey Roofe
Steve Olshewsky
Janey Moore
Richard Mitchell
Marian M. Taylor
Greg Apillow
Ann McDonald
Amy Thomas Laub
Kenny Book
Jody Lassiter
Hal Goode
Bob Quick
Rick Fluid
Andy Hightower
Robert Akin
Robert Riggs
Janey Moore
Tom Dupree
Geoff Young
Betty Whitaker
J. Henry Duncan
Stan Lampe
Les Renkey
Steve Boise
Jordan Wildermuth
William Stolte
Sarah Numan
Jessica Hiler
Lisa Holland
Reid Livingston

Cindy Heine
No Name TBD
Vivian Catteral
Tara Isaacs
Stephanie Winkler
President Capilouto
Scott Lockhart
David O'Neill
Rick Smith
Bill Rood
David Adams
Dr. Silvia Serelsoule
Ruby Cottingim

Louisville Transcripts
Harriet Syler
Larry Dodson
Damon Jackie
Terry Gail
Jodi Mitchell
Dean Johnson
Ramona Johnson
William H. Harned
Mack Bushart
Tony Lindauer
Mayor Greg Fisher
Dr. Janet Kelly
Eilene Pickett
Betsy James
Harry Borders
Art Williams
Larry Dodson
Scott Travis
Tom Underwood
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Trent Taylor
Albert Kline
Jim Medina
Greg Zaradnick
Molly Travazero
Mary Love
Layne Adams
Curtis Morrison
Gordon Syphert
Patrick King

John Harrelson
Walter Anderson
Paul Ogden
Eilene Pickett
Dale Bowden
Kurt Gillawater
Sarah Lynn Cunningham
John Wills
Larry Elder
Kevin Connelly
Louise Miller
Patrick Holman
Joetta Vetterman
Mary Shmuck
Marilyn Parker
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WRITTEN IDEAS SUBMITTED BY INDIVIDUALS

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Jeremiah Suhl, M.D.
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Gayl Kaler
Abbie Jones
Ted Munday
Mike Chmilewski
Dave Garrett
Jeffrey Hampton
Anne Hadreas
Arthur and Margaret Radin
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L.D. Gorman
Gary Feger
Charles Hoffman
William Kevin Mays
David Adkisson
Susan Crabbe
Jeanie Embry

Report to Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants

Final

Prepared for:

Governor's Blue Ribbon Commission on Tax Reform

September 19, 2012

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Executive Summary

Section 1: Introduction

- Two basic points come from our analysis of Kentucky's tax system: a broader tax base is needed so that revenue can keep pace with future economic growth, and changes are needed to improve Kentucky's economic competitiveness.
- Without fundamental reforms Kentucky could face a $1 billion shortfall by 2020, and could find itself at a competitive disadvantage to neighboring states for business growth, retention, and recruitment.
- The options we present below can improve future revenue growth and economic competitiveness—which are evaluated with respect to other important factors, such as fairness and simplicity. The Commission should view these options as alternative routes to a different tax system, but with varying implications for adequacy, elasticity, competitiveness, fairness, and simplicity.

Section 9: Policy Options

- These options are based on two core ideas—broadening the tax base will make the system more elastic, and shifting taxation away from business capital and labor earnings, and toward consumption, will make it more competitive.
- All of the options would change Kentucky's current tax system. However, some are modest changes of the existing structure while others represent a fundamental change in the current system. One can think of these options as existing along a continuum of change—from small to large.
- Our list of options is not exhaustive. There are many possible options available to the Commission—some of which might not be delineated in this report.
- Several of the options presented here are mutually exclusive. Pursuing some options would preclude the adoption of others. On the other hand, we present options whose effectiveness and applicability is contingent upon the adoption of others.
- The options are based on the premise that fairness is best evaluated through the entire tax system rather than through individual taxes.
- Given current tax rates, the base-broadening options will increase state revenue. However, it is not our intention to suggest that adoption of these base-broadening measures necessarily means that revenues need to increase. An alternative might be to adopt base-broadening measures in conjunction with reductions in tax rates. A small number of the options would reduce revenues but make Kentucky more competitive.

- Advantages of a broad tax base include:
  - a broader tax base will generally be more elastic;
  - a broader tax base will allow for lower tax rates, significantly reducing the inefficiencies associated with taxes and make Kentucky more competitive without the use of expensive and distortionary incentives;
  - a broader tax base will generally reduce differences in tax treatment of households or firms in similar economic conditions;

and

  - a broader tax base may simplify tax reporting and increase compliance.

- Advantages of more reliance on taxation of consumption and less on business capital and labor earnings include:
    - increase Kentucky's competitive position and employment in Kentucky by making it more attractive for firms to locate and invest in Kentucky;

and

    - reduce compliance costs for firms engaged in business in Kentucky;
- The ordering of the options is not intended to represent any ranking or recommendation. Instead, we begin with options for the largest source of revenue for the state, the individual income tax, and then order each of the taxes based on its share of revenue. The options for each of the taxes are, for the most part, ordered based on what the magnitude of the change in the tax, from minor reforms to the existing structure to sometimes an extremely different structure. The specific policy options we propose for the Commission's consideration are:

Individual Income Tax Options:

- Option 1: Conform the Kentucky Individual Code to the Federal Code as of a specific date
- Option 2: Enact a State Earned Income Tax Credit (EITC)
- Option 3: Tax Pension and IRA income
- Option 4: Make Taxable Income equal to Federal Adjusted Gross Income (AGI) less a significant standard deduction and tax credit for low income households

Sales Tax Options:

- Option 1: Broaden sales taxes to selected services
- Option 2: Impose a state gross receipts tax of up to 3 percent on providers of electricity for residential use
- Option 3: Impose the sales tax on food for consumption at home and provide a tax credit or other means for to offset the additional tax burden for low-income households
- Option 4: Exempt business purchases of energy
- Option 5: Impose a gross receipts tax of between 1 and 3 percent on both residential and business electricity.
- Option 6: Support federal legislation allowing states to require remote firms to collect the sales tax.

Business Tax Options:

Reform the existing corporate and LLET tax structures:

- Option 1: Conform the corporate income tax base with Federal Code as of a specific date
- Option 2: Addback management fees in calculation of the corporate income tax base
- Option 3: Use Destination Sourcing for Services
- Option 4: Lower the $3.0 million LLET threshold to $1.0 million and phase out the effects through $2.0 million
- Option 5: Replace the double-weighted sales formula with single factor sale apportionment for the Corporate Income Tax.

Major reform:

- Option 6: Replace the Corporate Income Tax and LLET with a Gross Receipts tax or with some other sources of revenue.

Property tax reforms

- Option 7: Eliminate personal property taxation
- Option 8: Exempt inventory from property taxation and eliminate the Barrel Tax
- Option 9: Freeze the state property tax rate at 12 cents per $100 of value

Local Tax Options:

- Option 1: Permit a Local General Sales Tax

Section 2: Characteristics of Kentucky's Tax System

State Tax Revenue

- Among its competitor states, Kentucky ranked 2nd in state tax revenue per capita in 2011, collecting $2335 per capita or 7.3% of income.
- State tax revenue sources for Kentucky and its competitors are similar, with Kentucky taxing property more and sales and individual income relatively less than its competitors.

State and Local Tax Revenue

- Kentucky ranks 10th in combined state and local own-source revenue per capita ($4905).
- The very different rankings of state and state and local tax burdens are due to the fact that 66% of state and local tax revenues is collected by state government in Kentucky while the median state share is 56% among all the competitor states.

State Tax Revenue Trends

- From 2006 to 2011 Kentucky has had a more stable revenue stream than competitor states. From 2006 to 2008, Kentucky revenues increased by less than 2 % and from 2008 to 2011 they decreased by only 5 %, much less than many states.

Personal Income Tax

- With the exception of the lowest income brackets, average tax rates (taxes/income) are from 1% - 2% higher in Kentucky than for a weighted-average its competitor states.

State Sales Tax

- At 6%, Kentucky's general sales tax ranks fifth among the 13 states and is the median of sales taxing states.
- Kentucky's practice of not taxing food is followed by 4 of its 12 competitor states. Some of its competitors tax food at a lower rate.
- Kentucky and virtually all of its competitors do not tax prescription drugs and tax nonprescription medicines.

Selective Sales Taxes

- Kentucky's tax on gasoline at $0.295 a gallon is 3rd highest among its competitors.
- Kentucky's $0.60 a pack tax on cigarettes is in the middle for its competitors.
- The taxation of alcohol, particularly in Kentucky, is more complicated, than most other goods. In addition to excise taxes, alcohol is subject to the general sales tax, and in Kentucky wholesale tax as well as case taxes. Primarily because of the wholesale taxes on alcohol products, Kentucky has high taxes on alcohol – highest on wine among competitor states, second highest for beer, and among those states with unregulated sales, second highest for distilled spirit.

State Corporate Income Tax

- Kentucky has a flat corporate tax, in contrast to most of its competitors.
- Kentucky's top tax rate of 6% ranks as the third lowest rate among its competitors and is below the median of all corporate income taxing states.
- Five of Kentucky's competitors apportion using Double Weighted Sales and four use Sales only.

Section 3: Adequacy and Elasticity

- Kentucky faces a structural deficit that could reach $1 billion by 2020.
- Revenue growth in Kentucky has slowed in the last several years, especially when compared to earlier periods. From 2000 to 2011, tax revenue failed to keep pace with the economy or declined more than the economy[1] in eight years while revenue growth exceeded economic growth in three years.
- If the revenue trend demonstrated from 2000 to 2008[2] continues to 2020, then state government would decrease to below 6.5 percent of the economy—a level not seen since 1968 when it was 5.9 percent.
- Revenue elasticity for total tax revenue for 2000 – 2008 in Kentucky was 0.81 – a 10% increase in personal income only yields an 8.1% increase in tax revenue. For the individual income tax it was 0.82 and for the general sales tax it was 0.87

Section 4: Fairness and the Distribution of Taxes

General Sales and Excise Taxes

- Kentucky's general sales tax, like that of other states, is regressive. We estimate that households in the income range of $20,000 - $29,000 pay about 2.0% of their income in direct general sales taxes while those households with incomes from $120,00 – $149,999 pay about 1.2%.
- We estimate that expanding the base to include additional consumer services while keeping the rate at 6% will income range of $20,000 - $29,000 to over 3.0% of their income in direct general sales taxes and to about 1.6% for households in the $120,000 – $149,999 range.
- As alcohol, tobacco, and gasoline are all larger shares of income for lower-income households taxes on this goods are regressive as well.

Individual Income Taxes

- Throughout the income distribution and for different types of filers, individual income taxes tend to be 1% - 2% higher shares of income than the average of our competitors.

Section 5: The Competitiveness of the Kentucky Tax System

Income

- Kentucky's income per capita in 2010 was about 80% of the U.S. average, ranking it 11 out of 13 competitive states.

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[1] Kentucky tax revenue declined by 3.1% and personal income declined by 1.2% in 2009—the trough year of the Great Recession.

[2] Given the extraordinary nature of the Great Recession in the late 1990s we do not include data from 2009-2011 in this analysis.

- Kentucky, its competitor states, and the U.S. overall, experienced virtually the same income growth prior to 1990.
- After 1990 growth rates for the U.S. slowed, but continued to be strong for Kentucky and many of its competitor states.

Population

- Kentucky's population grew by approximately thirty percent from 1969 to 2010, slightly above the average of its competitor states but below the U.S. average.

Earnings

- From 1969 to 2010, real private earnings per employee grew about 35%, ranking it 10 out of the 13 competitive states.
- From 2001 to 2010, seven of the competitor states, including Kentucky, experienced a real decline in private earnings per employee.

Employment

- Total employment in Kentucky grew 80% from 1969 to 2010, placing it in the middle of the pack of competitive states.
- In the more recent period of 2001 to 2010, Kentucky's total employment grew about 3%, ranking it 7 out of the 13 competitive states.

Business Taxes

- Kentucky ranks third highest in business taxes as a percentage of private sector gross state product in 2011.
- In contrast, studies comparing Kentucky's taxation of new and mature investment to other states for different facility forms suggests that Kentucky compares favorably to most of its competitors. The Ernst&Young/Cost study places Kentucky as having the fourth lowest tax rate on new investment among its 13 competitor states.

Taxes and Economic Development

- A review of the extensive literature in economics on the impact of state taxes on measures of economic activity such as employment, investment, and gross state product suggests that taxes do reduce economic activity. However, the magnitude of the impact is reduced when public services are accounted for in the estimation.

Section 7: Local Tax Issues

- Kentucky has a very centralized revenue system with 65% of state and local revenue collection being done by the state government.
- Local governments in Kentucky finance through very different revenue sources than most states. Kentucky local governments are less reliant on the property taxes, much more reliant in individual income (occupational license) taxes, and do not have the option to tax general sales taxes.
- In only 15 states do states not have the option to have a local general sales tax and in only 15 states do local governments have the authority to tax income.

Summary and Scoring of Tax Reform Options*

Option		Score	Elasticity	Progressivity	Horizontal Equity	Simplicity	Competitiveness	Other States
Individual Income Tax Options:								
1	Conform the Kentucky Individual Code with Federal Code as of a specific date	Negative $9.0 million initially, lower over time.	+	0	+	+		NC, SC, GA, IL, IN, MO, OH, VA[1]
2	Enact a State Earned Income Tax Credit (EITC)	$-45.0 million [2.]	+	+	0	0		IL, IN, VA
3	Increase the taxation of Pension and retirement income	+$145.0 million [3.]	+	0/+	+	+		GA, IN, MO, NC, OH, SC, VA, WV
4	Make Taxable Income equal to Federal Adjusted Gross Income (AGI) less a standard deduct and tax credit for low-income households	+780.0 million, making flat tax at 6.0%. Neutral at 4.0 percent	+	0/+	+	+	+	OH, IL, IN
Sales Tax Options								
1	Broaden sales taxes to selected services	+$176.4 million	+	+	+	-/0		NC, SC, GA, AL, TN, OH, MS, WV
2	Impose a state gross receipts tax of up to 3 percent on providers of electricity for residential use	+360.0 million	+	0	+	-/0		
3	Impose the sales tax on food for consumption at home.	+484.0 million	+	-	+	+		IL, MO, TN, VA, WV
4	Exempt business purchases of energy	-124.0 million	0			+	+	
5	Impose a gross receipts tax of between 1 and 3 percent on both residential and business electricity						+	
6	Support federal legislation allowing states to require remote firms to collect the sales tax.	+120 million, pending review of the final legislation	+	+	+	-	+	

*The notation "+,-,0" means that the option will increase (+), have no impact (0), or decrease (-) the tax code with respect to that criterion. A "+" in "progressivity," for example, means progressivity is increased with that option but does not imply any judgment about the merits of increasing progressivity. A blank cell means that the impact of the option on the criterion is difficult to ascertain though likely small. The scoring and evaluation of each option is made given no other changes in Kentucky's tax structure. As it is unlikely that many of these options are done in isolation this assumption probably overstates the impacts of the options.

Summary and Scoring of Tax Reform Options (continued)*

Option		Score	Elasticity	Progressivity	Horizontal Equity	Simplicity	Competitiveness	Other States
Business Tax Options								
	Reform the existing CIT and LLET							
1	Conform the corporate income tax base with Federal Code as of a specific date	Negative $16.0 million initially, lower over time.	+			+	+	
2	Addback management fees in calculation of the corporate income tax base	+13.0 million	+				+	12 states
3	Use Destination Sourcing for Services	Final Score Pending					+	IL, GA, AL
4	Lower the $3.0 million LLET threshold to $1.0 million and phase out the effects through $2.0 million	+$14.2 million	+				+	
5	Replace the double-weighted sales formula with single factor sales apportionment for the Corporate Income Tax.	$-64.0 million					+	GA, IL, IN, SC
	Major Reform							
6	Replace the Corporate Income Tax and LLET with a Gross Receipts tax or with some other sources of revenue	Revenue Neutral depending on GRT tax rate	+			+	+	OH
	Property Tax Options							
7	Eliminate personal property taxation	Final Score Pending	+			+	+	OH
8	Exempt inventory from property taxation and eliminate the Barrel Tax	-$4.7 million	+			+	+	
9	Freeze the state property tax rate at 12 cents per $100 of value		+			+	0	
	Local Tax Options							
1	Permit a Local General Sales Tax		+			-		TN, VA, IL, IN,

1. North Carolina and South Carolina conform to federal AGI while the remainder of states listed conforms to taxable income.
2. Assuming a Low Income Credit at 5% of the Federal Credit
3. Assuming a phase-out of existing exemption
4. Includes tax loss from PTE using the individual income tax

*The notation "+,-,0" means that the option will increase (+), have no impact (0), or decrease (-) the tax code with respect to that criterion. A "+" in "progressivity," for example, means progressivity is increased with that option but does not imply any judgment about the merits of increasing progressivity. A blank cell means that the impact of the option on the criterion is difficult to ascertain though likely small. The scoring and evaluation of each option is made given no other changes in Kentucky's tax structure. As it is unlikely that many of these options are done in isolation this assumption probably overstates the impacts of the options.

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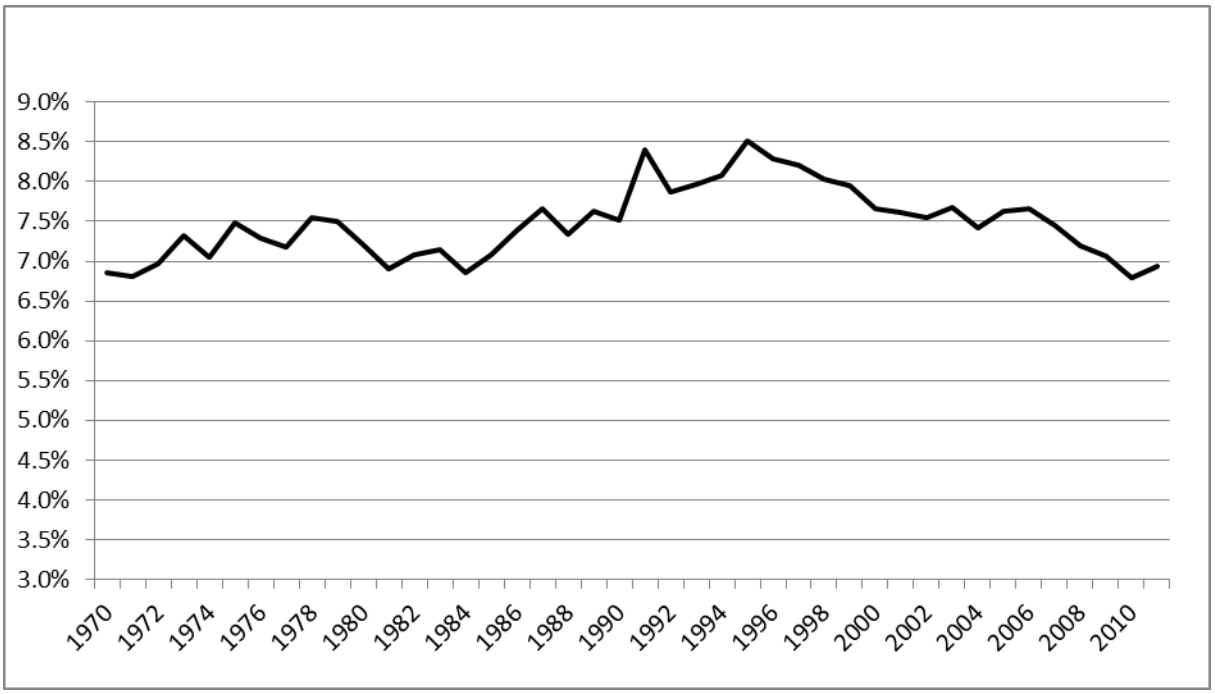
1. *Introduction*

1.1 Why Tax Reform Now?

Two basic points come from our analysis of Kentucky's tax system: a broader tax base is needed so that revenue can keep pace with future economic growth, and changes are needed to improve Kentucky's economic competitiveness. Without fundamental reforms Kentucky could face a $1 billion shortfall by 2020, and could find itself at a competitive disadvantage to neighboring states for business growth, retention, and recruitment. The options we present below can improve future revenue growth and economic competitiveness—which are evaluated with respect to other important factors, such as fairness and simplicity. Just as there are many routes to the same destination—some shorter, others faster, and some more scenic—the Commission should view these options as alternative routes to a different tax system, but with varying implications for adequacy, elasticity, competitiveness, fairness, and simplicity.

Our examination of revenue trends suggests important changes over the last several years that are likely to continue into the foreseeable future. *Figure 1.1* shows Kentucky state tax collections from 1970 to 2011 as a percentage of personal income. As the figure shows, as a share of income, revenue peaked in 1995 and has been declining since. Revenues have not kept pace with personal income and our analysis suggests this trend will continue without changes to the tax system.

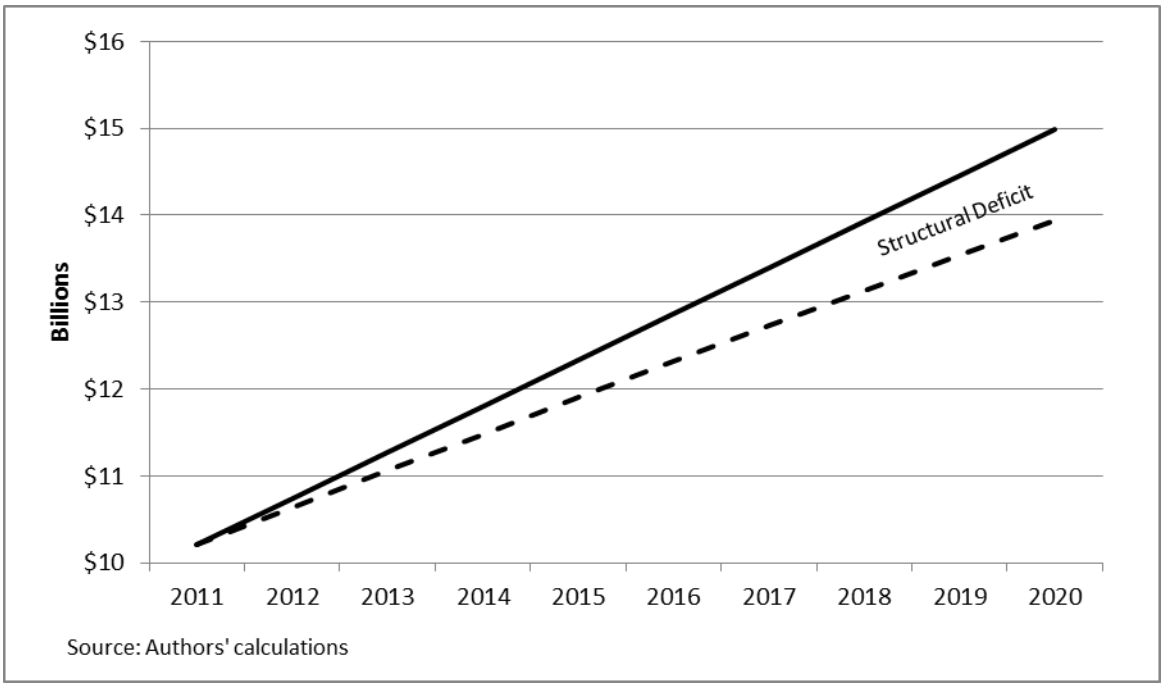
Figure 1.1: Kentucky Total State Tax Collections as a Percentage of Personal Income, 1970-2011



If expenditures remain a relatively stable share of personal income in the future, revenues will not keep pace. Then based on the relationship we estimate between personal income and tax revenue and if expenditures remain a stable share of income, Kentucky will have a structural deficit that could reach $1 billion by 2020 as illustrated in *Figure 1.2*. We return to this discussion in more detail in *Section 3*.

That tax revenues under the current tax code do not keep pace personal income need not imply an increase in taxes is needed. An alternative strategy would be a reduction in expenditures. However, what these recent trends suggest is that if spending, above or below current levels, is to be relatively stable as a share of income, we do not have the tax structure to support it.

Figure 1.2: Simulated Kentucky Revenue



1.2 What is Tax Reform?

The answer probably depends upon who you ask. Some may say it means tax increases; others may say it means decreases in taxes. While whether state tax revenues need to increase or decrease is certainly important, this is as much an issue about state expenditure policies as it is tax policy. We remain agnostic on this question, only providing some information to the Commission that may help them address these issues.

It is our view that tax reform is as much or more about *how* we tax as *how much* we tax. The impacts of the tax on the economy – households and businesses alike – not only depend on how much we are taxed but how. Differences in how we collect taxes, even if the amount we collect is the same, will have different effects on Kentucky's competitiveness, how our revenue stream grows, the distribution of tax burden, and how efficiently our economy operates. A large part of our task in this report is to explain the impacts of these different tax options on Kentucky's economy.

1.3 *Our Review of Kentucky's Tax System*

Our charge is to evaluate Kentucky's tax system with respect to five issues: adequacy, elasticity, fairness, competitiveness, and simplicity and compliance. In addition to examining and describing Kentucky's tax system we were also asked to compare our code to our competitor states. After this review and comparisons are made, we offer a number of options for reforming the tax code.

In *Section 2* we discuss characteristics of the Kentucky tax system and examine trends in tax revenue. We also provide some comparisons of the Kentucky's tax system with its competitor states of Alabama, Georgia, Illinois, Indiana, Mississippi, Missouri, North Carolina, Ohio, South Carolina, Tennessee, Virginia, and West Virginia.

Our discussion of the adequacy and elasticity of the Kentucky tax system is found in *Section 3*. Measurement of adequacy can be an esoteric and theoretical discussion that would not be very useful to the Commission, but ultimately it depends on what the residents of Kentucky desire in public services. We can we provide very useful information on recent trends in Kentucky expenditures and how our current revenues and expenditures compare historically and how they compare with other states. In this section we estimate the elasticity of Kentucky's tax base, how tax revenue grows with personal income, and discuss some of the implications for future revenue stability.

Fairness and the distribution of tax burden are the topics of *Section 4*. Like adequacy, we have no expertise in what makes a "fair" tax system. Instead, we provide information about the distributional impacts of Kentucky's tax system and how they compare to those in competitor states.

In *Section 5* we discuss issues of competitiveness. We begin by comparing economic growth in Kentucky with that of its competitors. In this section, we also review and summarize some studies comparing tax burdens on businesses across states. Finally, we offer a review of the myriad of studies examining the impact of state and local taxation on employment and firm location.

Section 6 discusses the issues of simplicity and compliance while *Section 7* discusses local tax issues. In *Section 8,* we discuss recent tax reforms in the competitor states and Kentucky as well as other recent studies of tax reform in Kentucky. Finally, in *Section 9* we propose some options for tax reform. We discuss these more fully next.

1.4 *Tax Policy Options*

In *Section 9,* we provide a discussion of the details on and rational for the proposed reforms we list below. The proposed options are based on two underlying themes– broadening the tax base and relying more heavily on taxation of consumption and less on business capital and labor earnings.

The options we suggest are not the only options consistent with these two themes and might be considered starting points for other options the commission might consider. Many of these options are mutually exclusive; some options, as we discuss later, are most effective in conjunction with the adoption of other options. The options are based on the premise that fairness is best evaluated through the entire tax system rather than through individual taxes.

The options we propose focus on modifications, some modest and others more radical, of the tax base. Given current tax rates, these base-broadening options will increase state revenue. However, it is not our intention to suggest that adoption of these base-broadening measures means that revenues need increase -- an alternative might be to adopt base-broadening measures in conjunction with reductions in tax rates. A small number of the options would reduce revenues but make Kentucky more competitive.

- Advantages of a broad tax base include:
  - a broader tax base will generally be more elastic;
  - a broader tax base will allow for lower tax rates, significantly reducing the inefficiencies associated with taxes and make Kentucky more competitive without the use of expensive and distortionary incentives;
  - a broader tax base will generally reduce differences in tax treatment of households or firms in similar economic conditions;

and

  - a broader tax base may simplify tax reporting and increase compliance.

- Advantages of more reliance on taxation of consumption and less on business capital and labor earnings include:
  - increase Kentucky's competitive position and employment in Kentucky by making it more attractive for firms to locate and invest in Kentucky;

and

  - reduce compliance costs for firms engaged in business in Kentucky.

The ordering of the options is not intended to represent any ranking or recommendation. Instead, we begin with options for the largest source of revenue for the state, the individual income tax, and then order each of the taxes based on its share of revenue. The options for each of the taxes are, for the most part, ordered based on what the magnitude of the change in the tax, from minor reforms to the existing structure to sometimes an extremely different structure. The specific policy options we propose for the Commission's consideration are:

Individual Income Tax Options:

- Option 1: Conform the Kentucky Individual Code with Federal Code as if a specific date
- Option 2: Enact a State Earned Income Tax Credit (EITC)
- Option 3: Tax Pension and IRA income
- Option 4: Make Taxable Income equal to Federal Adjusted Gross Income (AGI) less a significant standard deduction and tax credit for low income households

Sales Tax Options:

- Option 1: Broaden sales taxes to selected services
- Option 2: Impose a state gross receipts tax of up to 3 percent on providers of electricity for residential use
- Option 3: Impose the sales tax on food for consumption at home and provide a tax credit or other means for to offset the additional tax burden for low-income households
- Option 4: Exempt business purchases of energy
- Option 5: Impose a gross receipts tax of between 1 and 3 percent on both residential and business electricity.
- Option 6: Support federal legislation allowing states to require remote firms to collect the sales tax.

Business Tax Options:

Reform the existing corporate and LLET tax structures:

- Option 1: Conform the corporate income tax base with Federal Code as of a specific date
- Option 2: Addback management fees in calculation of the corporate income tax base
- Option 3: Use Destination Sourcing for Services
- Option 4: Lower the $3.0 million LLET threshold to $1.0 million and phase out the effects through $2.0 million
- Option 5: Replace the double-weighted sales formula with single factor sale apportionment for the Corporate Income Tax.

Major reform:

- Option 6: Replace the Corporate Income Tax and LLET with a Gross Receipts tax or with some other revenue sources.

Property tax reforms

- Option 7: Eliminate personal property taxation
- Option 8: Exempt inventory from property taxation and eliminate the Barrel Tax
- Option 9: Freeze the state property tax rate at 12 cents per $100 of value

Local Tax Options:

- Option 1: Permit a Local General Sales Tax

2. Characteristics of Kentucky's Tax System

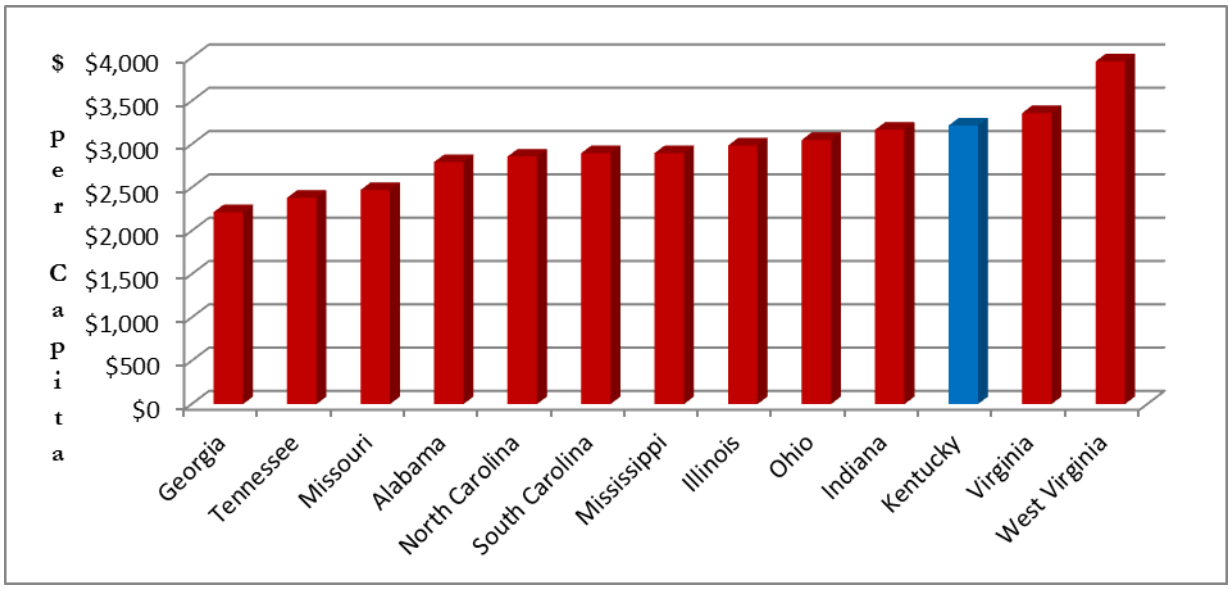
Before we directly address the five criteria for evaluating the Kentucky tax system and offer some policy options for reform, we first offer a brief overview of the system – what taxes does Kentucky use and how does this use compare to its competitor states. [3] We begin with an examination of total revenue collections then examine state personal income taxes, state sales and selective sales taxes, and corporate income taxes in more detail. A brief summary of the more detailed report, particularly information found in the tables and figures is found below.

Below we provide some data on and discussion of current state tax practices in Kentucky and its competitor states.

2.1 Revenue Collections

Figures 2.1A and 2.1B report total state revenue in per capita terms and as a percentage of income for Kentucky and its "competitor" states[4] for fiscal year 2009. This revenue includes not only tax revenue but revenue from fees and operating charges for state operations. As can be seen in the table, Kentucky collects $2335 in state revenue per capita or about ten percent of state personal income. In per capita terms, this is third behind Virginia and West Virginia and in per capita terms, second only to West Virginia.

Figure 2.1A: Total State Revenue per Capita (2009)

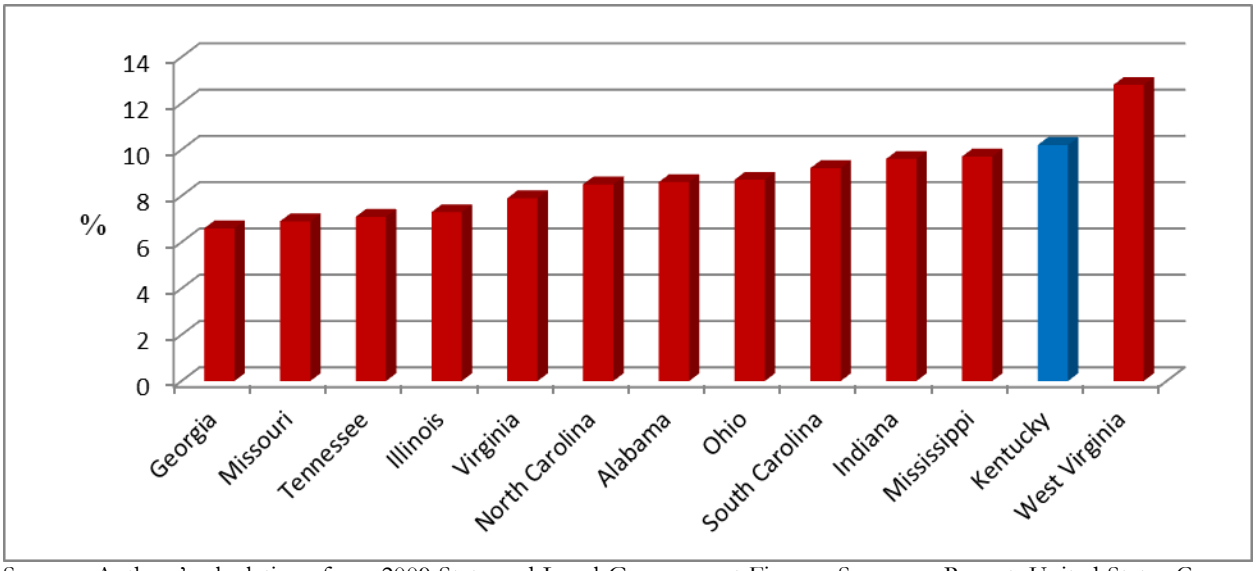


Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

[3]Competitor states include Alabama, Georgia, Illinois, Indiana, Mississippi, Missouri, North Carolina, Ohio, South Carolina, Tennessee, Virginia, and West Virginia.

[4] Competitor states as designated by Cabinet for Economic Development that include Alabama, Georgia, Illinois, Indiana, Mississippi, Missouri, North Carolina, Ohio, South Carolina, Tennessee, Virginia, and West Virginia.

Figure 2.1B: Total State Revenue as a Percent of Income (2009)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

Figure 2.2 compares the percentage of revenue collected by each reported tax source for Kentucky and a weighted-average of its competitor states.[5] As the figure shows, Kentucky's state revenue sources are similar to those of its competitors. Kentucky relies somewhat less on the sales tax and personal income tax than its competitors, slightly more on selective sales taxes, and significantly more on the state property tax. More detail on the revenue sources of specific states can be found in *Table A.1* in the *Appendix* to this report.

Figure 2.2: State Tax Revenues by Source (2009)

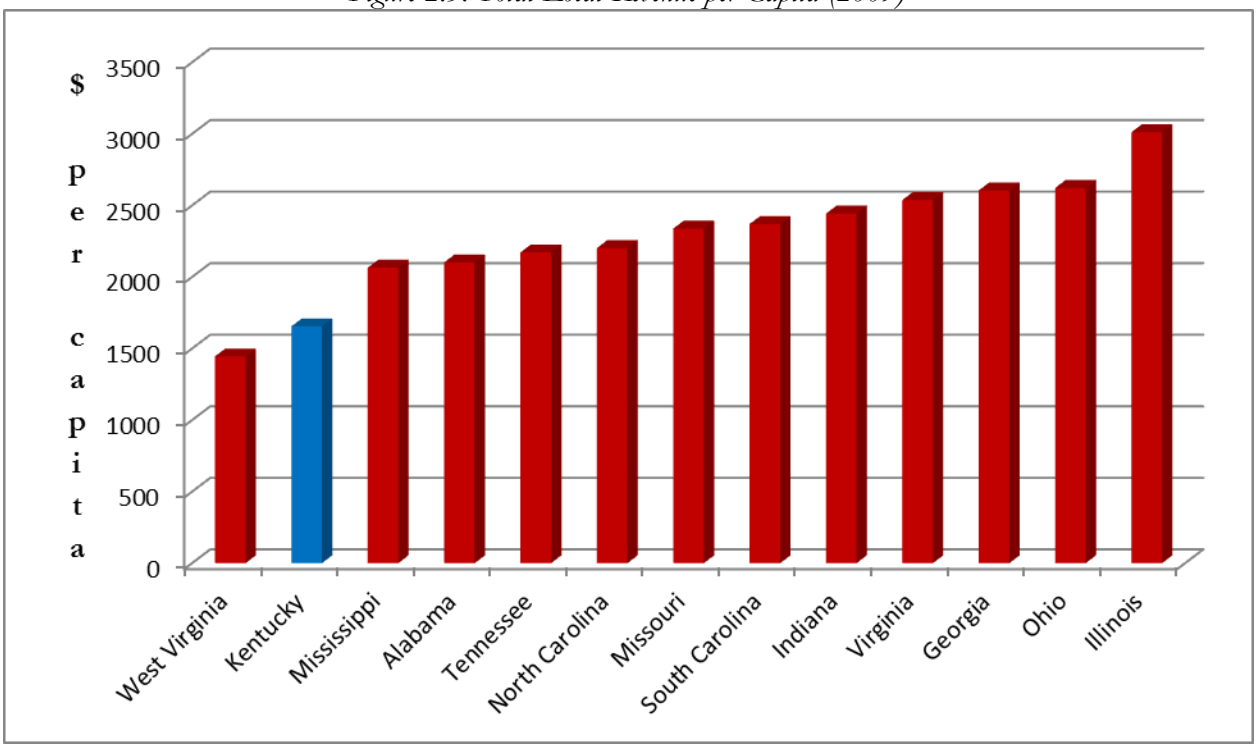
Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

[5] The weight used is total tax revenue in the state to determine the weighted average.

2.1.1 State and Local Tax Collections

When local taxes are considered along with state taxes, a very different picture of how Kentucky compares to its competitor states emerges. Figure 2.3 illustrates local government revenue collections (per capita) for Kentucky and its competitor states for 2009. The ranking of states is almost the reverse of that for state taxation with West Virginia having the lowest local revenue per capita and Kentucky second lowest with just of $1,500 per capita in local revenues.

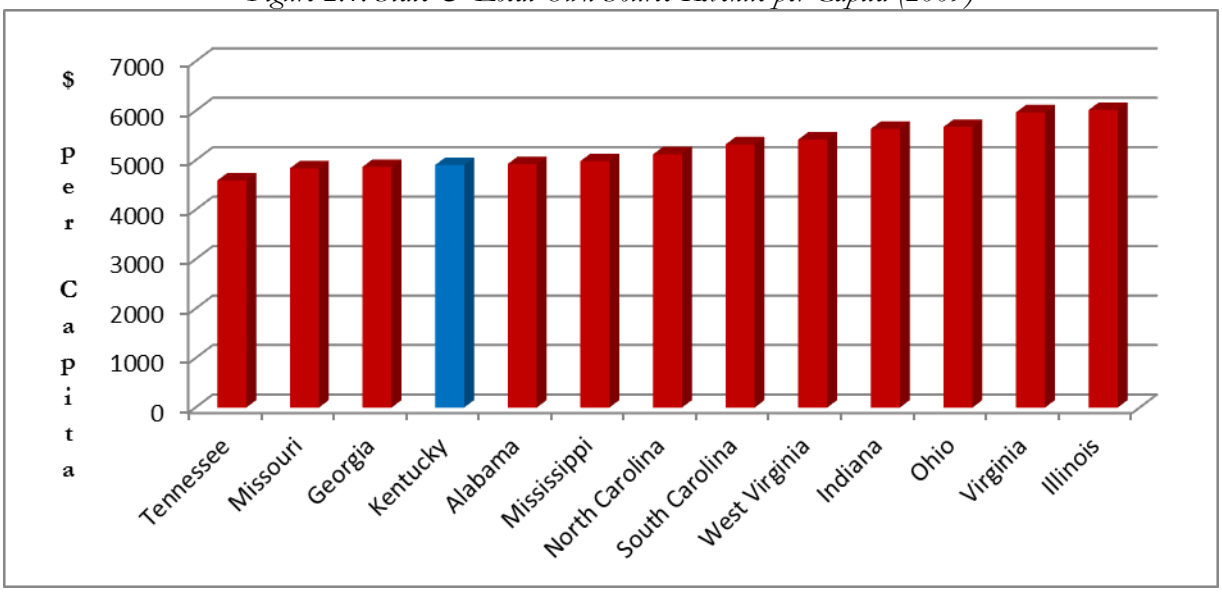
Figure 2.3: Total Local Revenue per Capita (2009)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

Then a comparison of revenue burdens among states requires a consideration of both state and local revenue burdens. In *Figure 2.4* we report state and local own revenue burdens for Kentucky and its competitor states in per capita terms for 2009. When both state and local revenues are considered a very different view of Kentucky's tax and revenue burden, relative to its competitors emerges. On a per capita basis, Kentucky ranks tenth among the states in own-source state and local revenue and sixth as a share of income.

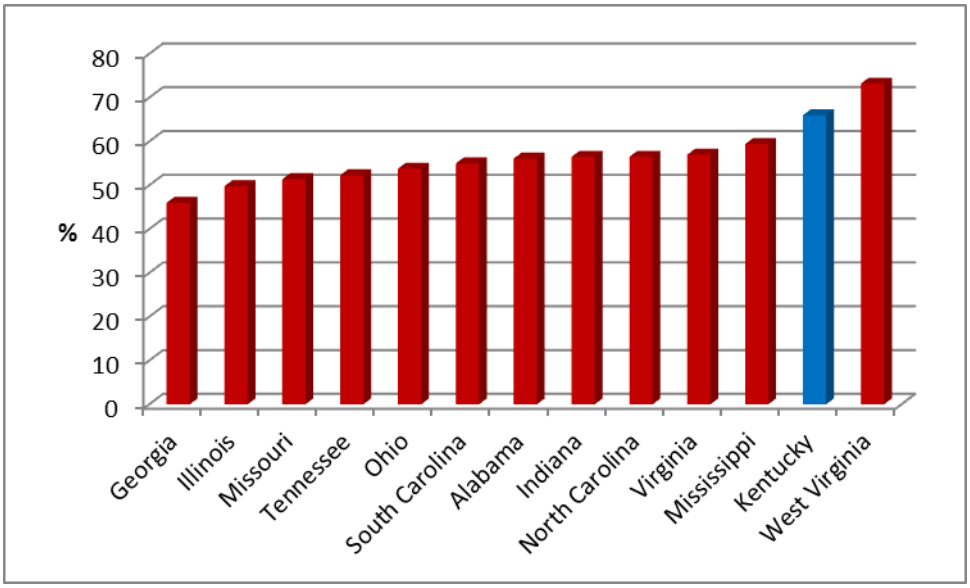
Figure 2.4: State & Local Own Source Revenue per Capita (2009)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

The difference in Kentucky's ranking in state tax burden and state and local tax or own-source burden is due to the fact that revenue collection in Kentucky is much more centralized than in its competitor states. As can be seen in *Figure 2.5*, the state government in Kentucky collects 66.0 percent of state and local own-source revenues; only West Virginia, which collects 73.2 percent through the state, is more centralized. All the other states collect less than 60 percent through state sources with a few (Georgia, Illinois) collecting over 50 percent from local revenue sources.

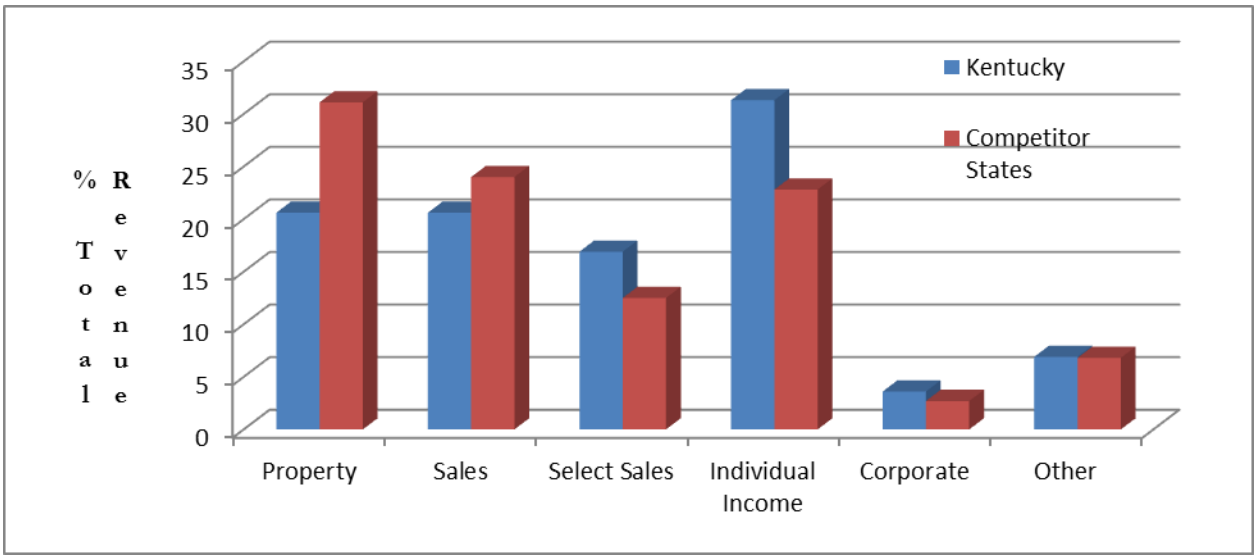
Figure 2.5: State Share of State and Local Revenue, Kentucky and Competitor States (2009)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

Consideration of local taxation not only changes Kentucky's tax burden relative to its competitor states but also its sources of revenue. In *Figure 2.6* we report the percentage of revenue collected by each reported tax source for Kentucky and a weighted-average of its competitor states.[6] When comparing combined state and local taxes, Kentucky appears less similar to its competitors than when simply comparing state taxes. Kentucky is significantly less reliant on property taxes than its competitors, who raise a much larger share of local tax revenue from the property tax, and particularly those to the north of Kentucky. Kentucky has no general sales tax option for any local governments, something a number of its competitor states (and 35 states in the U.S.) allow. Unlike many of its competitors, Kentucky allows local individual income (occupation license) taxation (only 13 states permit local income taxation). Not surprisingly, then, Kentucky collects a smaller share of combined state and local tax revenues from sales taxation and more from income taxation.

Figure 2.6: State and Local Tax Revenues by Source (2009)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

2.2 Structural and Rate Differences in Kentucky and Competitor State Taxes

In the sections of the report that follow, we discuss important issues regarding the performance of the Kentucky tax system and some of the major tax resources in the state. We discuss the adequacy and elasticity of the tax system in the next section, following with some discussion of fairness and the distribution of tax burden in Section 4, and discuss the competiveness of the tax system in Section 5. However, before discussing these issues of performance, to better understand the performance of the Kentucky tax system we believe it will be instructive to discuss some institutional aspects of the major sources of tax revenue in Kentucky and compare them to those in competitor states. We begin with the individual income tax.

[6] The weight used is total state and local tax revenue in the state to determine the weighted average.

2.3 The Individual Income Tax

Tax Rates and Brackets

Table 2.1 reports the range of tax rates, number of brackets, the lowest and highest income brackets, personal exemptions, and relationship with the federal income tax rate for Kentucky and its competitor states as of January 2012. Kentucky's system is relatively similar to most of its competitors with the obvious exception of Tennessee which only taxes dividends and interest income. Illinois and Ohio have flat rates of 5% and 3.4%, respectively, and on the other end, North Carolina, South Carolina, and West Virginia have top bracket rates of 7.75%, 7.00%, and 6.5%. The income subject to the highest rate varies with Kentucky's being relatively high at $75,001. Kentucky is in the middle with respect to the level of income at which taxpayers first need to pay ($3,000) with the flat rate states (Illinois, Indiana) having households pay taxes on all taxable income while Alabama starts taxation after $500 of taxable income. In contrast, West Virginia does not have households pay on the first $10,000 of income and North Carolina has no tax on the first $12,750 for single tax payers and $21,250 for taxpayers filing jointly.

2.3.1 Tax Treatment of Pensions and Social Security

A significant number of states treat pension income differently from earnings, specifically, exempting at least some of it from taxation. States vary significantly in how much pension income is exempt and the treatment of pensions from different sources: private, federal, state and local, and military. While states can treat private pensions differently from public pensions (federal, state and local, and military) two Supreme Court rulings (Davis v. Michigan (489 U.S. 803) and Barker v. Kansas (503 U.S. 594) prohibited state and local pensions from receiving exemptions when federal and military pensions do not.

Table 2.2 summarizes the current treatment of pension income and social security by Kentucky and its competitor states. As can be seen in the table, with the exception of Missouri, all of the states exempt social security income from taxation. Alabama. Illinois and Mississippi exempt all pension income from taxation. Kentucky is the next most generous state exempting $41,110 of each type of pension income from taxation with Georgia having a similar level of exemption ($35,000). The remainders of the competitor states have very limited exemptions of pension income. Of course, for Tennessee neither labor earnings nor pension income are taxes.

Table 2.1: Personal Income Taxes by State (2012)

	Tax Rate Range		# of Brackets	Income Brackets		Personal Exemptions			Federal Deductible	Federal Base
State				Lowest	Highest	Single	Married	Dependents		
Kentucky	**2.00**	**6.00**	**6**	**3000**	**75001**	**20 (c)**	**40 (c)**	**20 (c)**		**---**
Alabama	2.00	5.00	3	500 (b)	3001 (b)	1500	3000	500 (e)	Yes	AGI
Georgia	1.00	6.00	6	750 (h)	7001 (h)	2700	5400	3000		AGI
Illinois	5.00		1	FLAT		2000	4000	2000		AGI
Indiana	3.40		1	FLAT		1000	2000	2500 (i)		AGI
Mississippi	3.00	5.00	3	5000	10001	6000	12000	1500		AGI
Missouri	1.50	6.00	10	1000	9001	2100	4200	1200	Yes (m)	Taxable
North Carolina	6.00	7.75	3	12750 (p)	60000 (p)	1150	2300	1150		AGI
Ohio (a)	0.59	5.93	9	5100	204200	1650 (r)	3300 (r)	1650 (r)		Taxable
South Carolina	0.00	7.00	6	2800	14000	3700 (d)	7400 (d)	3700 (d)		---
Tennessee	State Income Tax of 6% on Dividends and Interest Income Only					1250	2500			AGI
Virginia	2.00	5.75	4	3000	17001	930	1860	930		AGI
West Virginia	3.00	6.50	5	10000	60000	2000	4000	2000		0

Source: The Federation of Tax Administrators from various sources.

(a) 17 states have statutory provision for automatically adjusting to the rate of inflation the dollar values of the income tax brackets, standard deductions, and/or personal exemptions. Because the inflation-adjustments for 2012 are not yet available in some cases, the table may report the 2011 amounts.

(b) For joint returns, taxes are twice the tax on half the couple's income.

(c) The personal exemption takes the form of a tax credit instead of a deduction.

(d) These states use the personal exemption amounts provided in the federal Internal Revenue Code.

(e) In Alabama, the per-dependent exemption is $1,000 for taxpayers with state AGI of $20,000 or less, $500 with AGI from $20,001 to $100,000, and $300 with AGI over $100,000.

(h) The Georgia income brackets reported are for single individuals. For married couples filing jointly, the same tax rates apply to income brackets ranging from $1,000, to $10,000.

(i) In Indiana, includes an additional exemption of $1,500 for each dependent child.

(m) The deduction for federal income tax is limited to $5,000 for individuals and $10,000 for joint returns in Missouri.

(p) The income brackets reported for North Carolina are for single individuals. For married taxpayers filing jointly, the same tax rates apply to income brackets ranging from $21,250, to $100,000.

(r) Ohio provides an additional tax credit of $20 per exemption. 2012 tax rates and brackets reported.

Table 2.2: Tax Treatment of Pensions and Social Security (2009)

		Exemption Amount					
State	**Social Security**	**Private**	**Military**	**Federal**	**State & Local**	**Age Minimum**	**Income Restrictions**
Alabama	Full	Full	Full	Full	Full	No	No
Georgia	Full	$35,000	$35,000	$35,000	$35,000	Yes (62)	No
Illinois	Full	Full	Full	Full	Full	No	No
Indiana	Full	None	$2,000	$2,000	None	Yes (62)	No
Kentucky[1]	Full	$41,110	$41,110	$41,110	$41,110	No	No
Mississippi	Full	Full	Full	Full	Full	No	No
Missouri	None	$4,000 applied to cap	$6,000 (single) $12,000 (joint)	$6,000 (single) $12,000 (joint)	$6,000 (single) $12,000 (joint)	No	Yes
North Carolina	Full	$2,000 (single) $4,000 (joint)	$4,000 (single) $8,000 (joint)	$4,000 (single) $8,000 (joint)	$4,000 (single) $8,000 (joint)		No
Ohio	Full	A retirement income tax credit of up to $200 is allowed, depending on income.					No
South Carolina	Full	$3,000 (Under 65) $10,000 (Over 65)	$3,000 (Under 65) $10,000 (Over 65)	$3,000 (Under 65) $10,000 (Over 65)	$3,000 (Under 65) $10,000 (Over 65)		No
Tennessee		State Income Tax only applies to Interest and Dividends				NA	NA
Virginia	Full	$12,000	$12,000	$12,000	$12,000	Yes (65)	No
West Virginia	Full	None	$2,000 + amount based on years of service	$2,000	Full for Public Safety; $2,000 for other	No	No

Sources: State Taxation of Social Security and Pensions in 2006, Issue Brief AARP;

OLR Report, State Income Taxes on Pensions, State of Connecticut, July 16, 2008 http://www.cga.ct.gov/2008/rpt/2008-R-0413.htm

[1]Pensions fully exempt for those received prior to July 1, 1998.

[2]A senior citizen tax credit of $25 per tax return is allowed to filers age 65+. A one-time tax credit is available for lump-sum distributions to people over 65. The credit is $50 multiplied by remaining life expectancy

2.3.2 State Earned Income Credit Programs

The Federal Earned Income Credit (EIC) program was created in 1975 to provide relief from payroll taxes for low-income working family households (households with dependents under eighteen years of age). The program has now been expanded to include households without children with low incomes but employed. Unlike most cash transfer programs, the payment from EIC increases with earnings at low earnings levels with each $1.00 of earnings increasing EIC payments by $0.40. At higher levels of earnings the payment is reduced $0.21 for every $1.00 of earnings. The payments and eligibility depend on the household. For single person households with no children the maximum level of earnings the household could have is $13,660. A married household with no children is eligible as well household earnings are less than $18,740. Both households could receive a maximum credit of $464. In contrast a married household with two

children with earnings of less than $46,044 is eligible. The maximum benefit received by this type of household is $51,112.[7]

Most of the twenty-two states and District of Columbia that have a state EIC "piggyback" on the federal EIC, that is, the state EIC is some fraction of the Federal EIC. States differ in whether the credit is refundable or non-refundable. A refundable credit is one in which the taxpayer can receive a check for the difference between the amount of the credit and income tax liability when the credit exceeds the tax liability. A nonrefundable credit can only be used to offset income tax liability – no checks are ever sent to taxpayers.

As *Table 2.3* shows, three of Kentucky's competitor states, Illinois, Indiana, and Virginia, have state EITC programs. All piggyback off the federal EITC. Like other state EITC programs that are nonrefundable, the benefit is much greater in Virginia than the two competitor states, Illinois and Indiana, which have refundable credits. This is due in large part to the fact that a nonrefundable program does not have to write checks.[8]

Table 2.3: State Earned Income Credit Programs

State	Refundable	Structure
Illinois	Refundable	5% of Federal EITC
Indiana	Refundable	6% of Federal EITC
Virginia	Nonrefundable	20% of Federal EIC

From: Meade and Ziliak (2006).

To give some indication of the magnitude of the credit and how it varies with income, in Table *2.4* we provide a schedule for the federal credit for married household with two children as well as the credits for the three competitor states that have EIC piggyback programs. The maximum credit is obtained at incomes between 12,500 and 16,700 with credit declining after until the household is no longer eligible at an income of 40,950. Note that the maximum credit in Illinois is $256 and $307 in Indiana. In Virginia the maximum credit is $1,022 but this is a refundable credit so households without any income tax liability receive no credit.

[7]Information is from the IRS website, http://www.irs.gov/publications/p596/apa.html .

[8] Much of this discuss is adapted from E. Meade and J. Ziliak, "A State Earned Income Tax Credit: Issues and Options for Kentucky, University of Kentucky Center for Poverty Research Policy Insight #2, 2006. http://www.ukcpr.org/Publications/PolicyInsights-No2.pdf

Table 2.4: 2010 Federal Earned Income Credit Schedule and State Schedules

Income	Federal EITC	Illinois 5% EITC	Indiana 6% EITC	Virginia 20%EITC
2,000	810	41	49	162
4,000	1,610	81	97	322
6,000	2,410	121	145	482
8,000	3,210	161	193	642
10,000	4,010	201	241	802
12,000	4,810	241	289	962
14,000	5,112	256	307	1022
16,000	5,112	256	307	1022
18,000	4,831	242	290	966
20,000	4,411	221	265	882
22,000	3,991	200	239	798
24,000	3,571	179	214	714
26,000	3,151	158	189	630
28,000	2,731	137	164	546
30,000	2,311	116	139	462
32,000	1,891	95	113	378
34,000	1,471	74	88	294
36,000	1,051	53	63	210
38,000	631	32	38	126
40,000	211	11	13	42

Source: Authors' calculations and 2011 IRS 1040 instruction book

2.4 General Sales and Selective Sales Taxes

2.4.1 General Sales Taxes

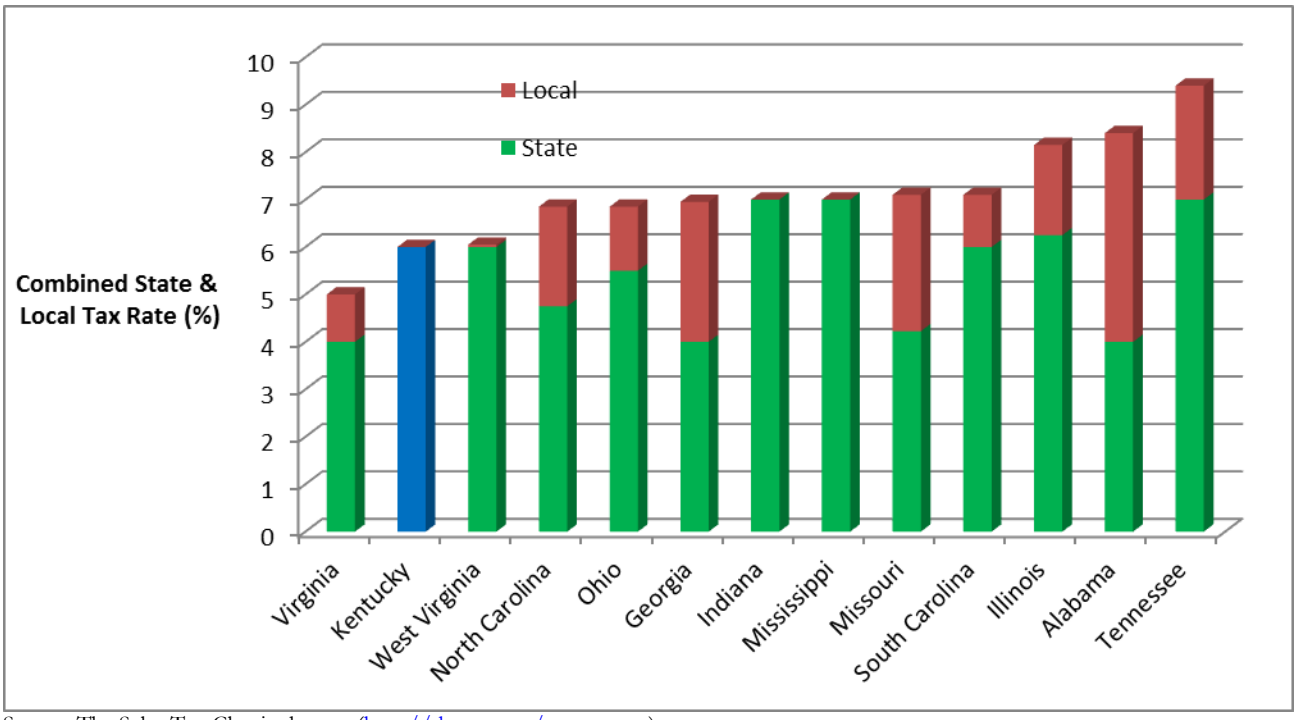
Table 2.6 lists state sales tax rates, exemptions and vendor discounts for Kentucky and its competitor states current as of January 1, 2012. Also listed are the average combined state and local sales taxes. As can be seen in *Table 2.5,* Kentucky's 6% state sales tax rate is the same as two other states, lower than four states, and above the rate in six states. However, as can be seen in both *Table 2.5* and *Figure 2.7* when Kentucky combined state and local sales tax rate is compared with its competitor states only Virginia has a lower average combined rate. The reason, for this difference in rankings is, of course, due to the fact that Kentucky has no local option sales tax unlike nine of its competitors. Like five of its competitors, exempts food from the sales tax; five states that do tax food, tax it at a lower rate. With the exception of a 1% tax by Illinois, Kentucky and its competitors do not tax prescriptions but almost all tax nonprescription medication.

Table 2.5: General Sales Taxes by State (2012)

	State Sales Tax		State and Local Combined			Exemptions		
State	Rate	Rank	Average Combined Rate	Rank	Vendor Discount	Food (%)	Prescriptions	Non-prescriptions
Kentucky	6.0	5	6.0	12	1.75-1.0 (1)	*	*	
Alabama	4.0	11	8.4	2	5.0-2.0 (1)		*	
Georgia	4.0	11	6.95	8	3.0-0.5 (1)	*	*	
Illinois	6.25	4	8.15	3	1.75	1	1%	1%
Indiana (1)	7.0	1	7.0	6	0.73 (2)	*	*	
Mississippi	7.0	1	7.0	6	2.0		*	
Missouri	4.225	10	7.1	4	2.0	1.225	*	
North Carolina	4.75	9	6.85	9	None	*	*	
Ohio	5.5	8	6.85	9	0.75	*	*	
South Carolina	6.0	5	7.1	4	3.0-2.0 (1)	*	*	
Tennessee	7.0	1	9.4	1	None	5.5	*	
Virginia (2)	4.0	11	5.0	13	3.0-1.5 (8)	2.5 (2)	*	*
West Virginia	6.0	5	6.05	11	None	2	*	

Source: Compiled by Federation of Tax Administrators (FTA) (http://www.taxadmin.org/fta/rate/tax_stru.html) and the Sales Tax Clearinghouse (http://thestc.com/strates.stm)
(1) Utilities are not permitted to take discount. Collection allowances are 0.73% if total sales tax collected is less than $60,000; 0.53% if total tax is between $60,000 and $600,000; 0.26% if total sales tax collected is more than $600,000.
(2) Rate does not include a statewide local rate of 1.0% in VA.

Figure 2.7 Combined State and Local Tax Rates (%) for Kentucky and Competitor States (2011)



Source: The Sales Tax Clearinghouse (http://thestc.com/strates.stm)

Sales Taxation of Services

The basis of most state sales tax systems has been tangible products, with the vast majority of services purchased by households exempt from the sales tax. Even though a minority of services available are taxed by states there is still significant variation in the extent of taxation of services among state. Exceptions are Hawaii, New Mexico, and South Dakota that broadly tax services. *Table 2.6* provides a summary of taxation of services by Kentucky and its competitor states.

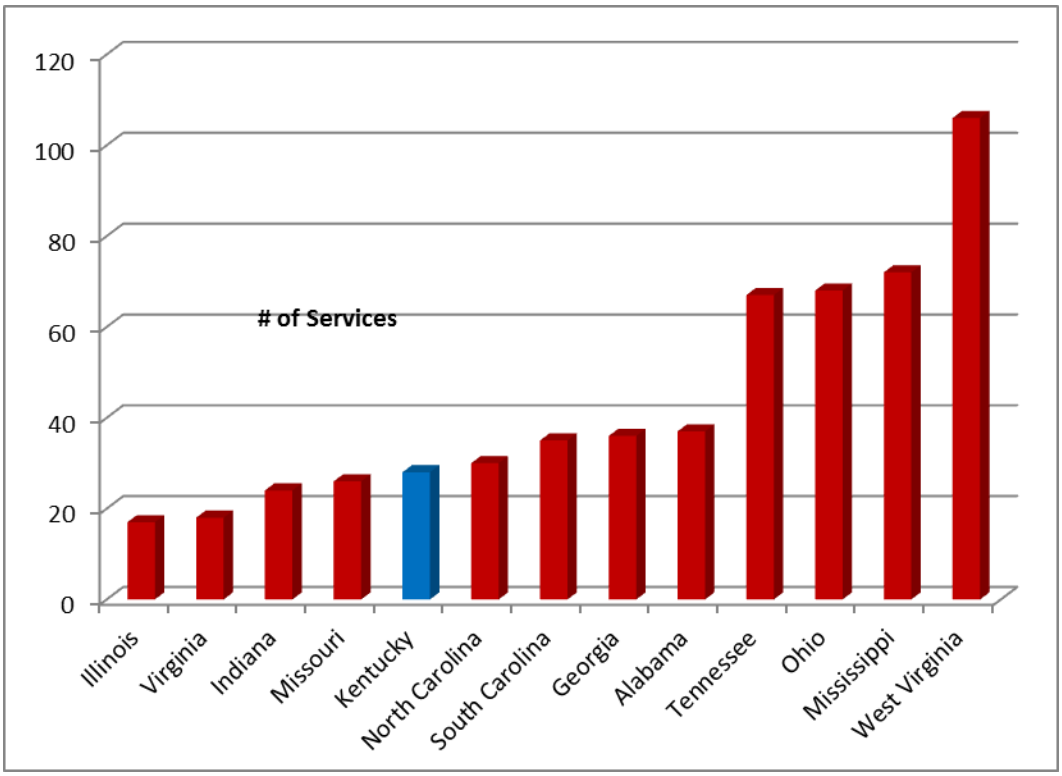
As can be seen more clearly in *Figure 2.8*, Kentucky taxes relatively few services when compared to its competitor states, ranking fifth lowest in service taxation. In evaluating the taxation of services, it is important to note that *Table 2.6* includes both business and consumer services. While Kentucky taxes fewer entertainment services (admissions and amusements) and automotive services than its competitors, much of the difference between Kentucky and its competitors that do tax a large number of services can be attributed to differences in the taxation of business services including agricultural services, industrial and mining services, construction, transportation, and storage. If attention is focused on consumer services, Kentucky base is not as comparatively narrow as when all services are considered.

Table 2.6 Sales Taxation of Services by Kentucky and Competitor States (2010)

	Alabama	Georgia	Illinois	Indiana	Kentucky	Mississippi	Missouri	North Carolina	Ohio	South Carolina	Tennessee	Virginia	West Virginia
Basic Sales Tax Rate	4	4	6.25	6	6	7	4.225	4.25	5.5	6	7	5	6
Totals													
Agricultural Services	0	0	0	1	0	2	0	0	1	0	1	0	3
Industrial and mining services	0	0	0	0	0	3	0	0	0	0	0	1	1
Construction	0	0	0	0	0	4	0	0	0	0	0	0	1
Utilities	12	10	12	7	11	10	8	10	8	4	11	1	6
Transportation	0	3	0	0	0	1	1	0	2	0	1	0	4
Storage	0	0	0	1	0	5	0	0	4	0	1	0	6
FIRE (Finance, Insurance, Real Estate	0	0	0	0	0	0	0	0	0	0	0	0	2
Personal services	2	4	1	4	2	5	1	4	12	6	10	3	17
Business services	6	5	1	3	4	8	2	5	14	7	7	4	27
Computer services	3	2	1	2	0	3	2	0	5	4	3	0	4
Automotive services	0	0	0	0	0	4	0	0	4	0	5	0	5
Admissions and amusements	10	8	0	3	6	11	10	9	3	10	12	1	13
Professional services	0	0	0	0	0	0	0	0	0	0	0	0	1
Leases	2	3	1	2	1	2	2	1	3	2	2	4	3
Fabrication, repair and installation	1	1	1	1	4	13	0	1	12	1	13	4	13
Miscellaneous	1	0	0	0	0	1	0	0	0	1	1	0	0
Non-exempt entries	37	36	17	24	28	72	26	30	68	35	67	18	106

Source: FTA, Survey of Sales Taxation of Services by States, 2007 (update 2010), http://www.taxadmin.org/fta/pub/services/services.html

Figure 2.8: Number of Tax Services by Kentucky and Competitor States (2010)



Source: FTA, Survey of Sales Taxation of Services by States, 2007 (update 2010) , http://www.taxadmin.org/fta/pub/services/services.html

2.4.2 Selective Sales Taxes

Table 2.7 lists the selective sales tax rates on gasoline, diesel fuel, cigarettes and other tobacco products for Kentucky and its competitor states as of January 1, 2012. These are taxes imposed on retail sales and do not include taxes imposed on distribution or production, some of which might be quite significant. Inspection of *Figure 2.9A* shows that Kentucky has the second highest tax on gasoline at $0.295 per gallon. In *Figure 2.9B* the tax rates on cigarettes are illustrated. Kentucky, at $0.60 per pack is the sixth highest among its competitors.

While the tax rate on gasoline in Kentucky is currently $0.295 per gallon, in fact, unlike its competitors, the tax on gasoline is not a fixed amount but instead an ad-valorem tax based on the current price of gasoline. The tax is 9% of the average wholesale price (AWP) of the first month of each quarter plus a $0.05 per gallon supplemental highway user tax and $0.014 per gallon environmental fee. The AWP may not increase by more than 10% over the AWP at the close of previous year but the AWP can decrease by more than 10% during a year. If this occurs, there is a floor on AWP for purposes of calculating the tax of $1.786 meaning that the 9% tax is $0.161 per gallon and the total minimum tax including the $0.05 highway user tax per gallon and $0.014 environmental fee per gallon makes a minimum tax of $0.225 per gallon.

Table 2.7: Selective Sales Taxes for Tobacco and Alcohol *by State (2011 and 2012)*[9]

State	Fuel		Tobacco	
	Gasoline	Diesel	Cigarettes	Other(3)
	($ per gallon)		($ per pack)	
Kentucky	0.295 (1)	0.234	0.60	15% WP
Alabama	0.16	0.19	0.425	0.03-0.405
Georgia	0.075	0.075	0.37	0.025
Illinois	0.19	0.215	0.98	18% WP
Indiana	0.18	0.16	0.995	24% WP
Mississippi	0.18	0.18	0.68	15% MP
Missouri	0.17	0.17	0.17	10% MP
North Carolina	0.389	0.389	0.45	12.8% WP
Ohio	0.28	0.28	1.25	17% WP
South Carolina	0.16	0.16	0.57	5% MP
Tennessee	0.20	0.17	0.62	6.6% WP
Virginia	0.175	0.175	0.30	10% MP
West Virginia	0.205	0.205	0.55	7% WP

Source: Tax Foundation (http://taxfoundation.org/tax-topics/state-tax-and-spending-policy) and Federation of Tax Administrators (http://www.taxadmin.org/fta/rate/tax_stru.html)

(1) Tax on gasoline and diesel is 9% of average wholesale price (2) All sales of alcohol in these states also subject to the state sales tax; (2) The government directly controls the sales of distilled spirits in these staes. (3) WP denotes wholesale price and MP denotes manufacturing price. (4) Includes the wholesale tax rate of 11%, converted to a gallon excise tax rate. (5) Includes case fees and/or bottle fees which may vary with the size of the container. (6) Includes sales taxes specific to alcoholic beverages. (7)) Local excise taxes excluded.

The taxation of alcohol, particularly in Kentucky, is more complicated, than most other goods. In addition to excise taxes, alcohol is subject to the general sales tax, and in Kentucky wholesale tax as well as case taxes. As shown in Table 2.8, primarily because of the wholesale taxes on alcohol products, Kentucky has high taxes on alcohol – highest on wine among competitor states, second highest for beer, and among those states with unregulated sales, second highest for distilled spirit.

[9]Tax rates for cigarettes and tobacco are as of January 1, 2012 while taxes on alcohol are as of September 1, 2012.

Table 2.8: *Tax Rates on Alcohol Produts*

	Beer				Wine				Distilled Spirits			
	Excise	Sales Tax	Other Taxes	Effective Rate	Excise	Sales Tax	Other Taxes	Effective Rate	Excise	Sales Tax	Other Taxes	Effective Rate
Kentucky	0.08	Yes	11%WP	23.96	0.50	Yes	11% WP	3.20	1.92	Yes	11%WP, 0.05 case; <6% .25;	6.85
Alabama	0.53	Yes	0.52 local	33.17	1.70	Yes	over 14% sold in State Store	1.70	State Store Sales Only			
Georgia	0.32	Yes	0.53 local	30.73	1.51	Yes	over 14% - 2.54; 0.83 local	1.51	3.79	Yes	0.83 local	3.79
Illinois	.235	Yes	0.29 in Chicago/.06 Cook	9.15	1.39	Yes	over 20% 8.55; 0.36 in Chicago 0.16-0.30 Cook	1.39	8.55	Yes	< 20% 1.39; 2.68 in Chicago/ 2.00 in Cook	8.55
Indiana	.115	Yes		5.89	0.47	Yes	over 21% 2.68	0.47	2.68	Yes	<15% 0.47	2.68
Mississippi	.4268	Yes		13.23	0.35	Yes	over 14% sold in State Store		State Store Sales Only			
Missouri	.06	Yes		1.86	0.30	Yes		0.42	2.00	Yes		2.00
North Carolina	.53	Yes		19.13	0.79	Yes	over 17% 0.91	1.06	State Store Sales Only			
Ohio	.18	Yes		6.13	0.30	Yes	over 14% 0.98	0.32	State Store Sales Only			
South Carolina	.77	Yes		23.81	0.90	Yes	0.18	1.08	2.72	Yes	5.36 case 9% surtax; 5% additional premise	5.42
Tennessee	.14	Yes	17 WP	37.00	1.21	Yes	0.15/case & 15% on premise	1.27	4.40	Yes	0.15 case' 15% premise < 7% 1.10	4.46
Virginia	.26	Yes		8.69	1.51	Yes	under 4% 0.26 & over 14% in state	1.51	State Store Sales Only			
West Virginia	.18	Yes		5.50	1.00	Yes	5% local	1.00	State Store Sales Only			

Source: Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/tax_stru.html (rates) and Beer Institute (effective rate for Beer) and Tax Foundation

2.5 Corporate Income Tax Rates

Table 2.9 reports state corporate income tax rates, tax bracket information, and apportionment formulas for Kentucky and its competitor states as of January 1, 2002. Unlike most of its competitors, Kentucky has more than a single rate, having three brackets with the tax rate ranging for 4 to 6 % with the 6 % effective after $50,000. Kentucky's 6 % top rate is lower than most of its competitor states, particularly Illinois, Indiana, and West Virginia and is below the median state's rate. Kentucky apportions its corporate income tax on Double Standard Sales with equal weights on sales, property, and payroll. Four of its competitor states apportion using double weighted sales while four states apportion using sales only.

Effective July 1, 2005 Ohio replaced its corporate income tax with a Commercial Activity Tax (CAT). The CAT applies annual tax to the gross receipts of all business in Ohio, including retailers, services, manufacturing, and other businesses with some exclusions for financial institutions, public utilities, and other businesses that may pay other specific Ohio taxes. In addition to its 7.0% corporate income tax Illinois has a net replacement tax, as of January 1, 2011 a tax of 2.5% on corporate net income less allowed investment credits.

In 2006 Kentucky imposed the Limited Liability Entity Tax (LLET) on all firms with limited liability including C-corporations, S-corporations and LLCs. The LLET imposes the minimum of 0.75 percent on profits or .095 percent of gross receipts. Limited liability entities with gross receipts under $3.0 million pay $175 in tax. Companies paying the corporate income tax are permitted a non-refundable credit against the LLET for corporate income taxes that are paid, which means that the LLET imposes a minimum tax on limited liability firms. However, unlike many other states, such as Tennessee, Kentucky does not impose the corporate income tax on LLCs. Failure to impose the corporate income tax on LLCs allows a tax planning opportunity by operating LLCs with a member that is located in a state (such as Delaware) that does not impose tax on the earnings from intangible assets.

Table 2.9: State Corporate Income Taxes (2012)

	Tax Rate Range		Number of Brackets	Tax Brackets		Tax Rate Financial Institutions	Federal Income Tax Deductible	Apportionment Formulas
State	Lowest	Highest		Lowest	Highest			
Kentucky*	**4**	**6**	**3**	**50,000**		**100001**	**--- (a)**	**Double std Sales**
Alabama*	6.5		1	----Flat Rate----		6.5	Yes	Double wtd Sales
Georgia	6		1	----Flat Rate----		6		Sales
Illinois*	9.5 (i)		1	----Flat Rate----		9.5 (i)		Sales
Indiana	8.5 (j)		1	----Flat Rate----		8.5		Sales
Mississippi	3	5	3	5,000	10001	3.0 - 5.0		Sales/Other (2)
Missouri*	6.25		1	----Flat Rate----		7	Yes (k)	3 Factor/Sales
North Carolina*	6.9		1	----Flat Rate----		6.9 (t)		Double wtd Sales
Ohio	(u)		0			--- (u)		Triple wtd Sales (3)
South Carolina	5		1	----Flat Rate----		4.5 (w)		Sales
Tennessee	6.5		1	----Flat Rate----		6.5		Double wtd Sales
Virginia	6		1	----Flat Rate----		6		Double wtd Sales
West Virginia*	7.5 (y)		1	----Flat Rate----		7.5 (y)		Double wtd Sales

Source: Compiled by FTA from various sources

(a) Rates listed are the corporate income tax rate applied to financial institutions or excise taxes based on income. Some states have other taxes based upon the value of deposits or shares.

(i) The Illinois rate of 9.5% is the sum of a corporate income tax rate of 7.0% plus a replacement tax of 2.5%.

(j) The Indiana tax rate is scheduled to decrease to 8% on July 1, 2012.

(k) 50% of the federal income tax is deductible.

(t) In North Carolina financial institutions are also subject to a tax equal to $30 per one million in assets.

(u) Ohio no longer levies a tax based on income (except for a particular subset of corporations), but instead imposes a Commercial Activity Tax (CAT) equal to $150 for gross receipts used to Ohio of between $150,000 and $1 million, plus 0.26% of gross receipts over $1 million. Banks continue to pay a franchise tax of 1.3% of net worth. For those few corporations for whom the franchise tax on net worth or net income still applies, a litter tax also applies.

(w) South Carolina taxes savings and loans at a 6% rate.

(y) West Virginia's corporate rate is scheduled for reduction as follows: 7.0% after 2012, 6.5% after 2013.

(2) Mississippi provides different apportionment formulas based on specific type of business. A single sales factor formula is required if no specific business formula is specified.

(3) Formula for franchise tax shown. Department publishes specific rules for situs of receipts under the CAT tax. The formulas listed are for general manufacturing businesses. Some industries have a special formula different from the one shown.

* State has adopted substantial portions of the UDITPA (Uniform Division of Income Tax Purposes Act). Slash (/) separating two formulas indicates taxpayer option or specified by state rules.

3 Factor = sales, property, and payroll equally weighted. Double wtd Sales = 3 factors with sales double-weighted Sales = single sales factor.

2.6 Severance Taxes

A description of severance taxes is found in Judy Zelio and Lisa Houlihan (2012)[10]:

> Severance taxes are excise taxes on natural resources "severed" from the earth. They are

[10]Source: Judy Zelio and Lisa Houlihan, "State Energy Revenues Update," National Conference of State Legislatures, (2012).

measured by the quantity or value of the resource removed or produced. In the majority of states, the taxes are applied to specific industries such as coal or iron mining and natural gas or oil production. They are usually payable by the severer or producer, although in a few states payment is made by the first purchaser. The taxes usually are imposed at a flat rate per unit of measure, with coal and ore mining taxes levied on a tonnage basis, oil production taxes on a per barrel basis, and gas production taxes on a per foot basis, although the rates may be graduated based on volume of production or value of the products. "Value" may mean market value in some states and gross value in others. Taxable net value or net proceeds are determined by deducting certain items from the gross value or gross proceeds. Examples of deductions include production costs, ad valorem taxes and royalties paid. Evaporation for gas wells also might qualify as a deduction.

Kentucky's coal severance tax was enacted in 1972 and expanded in 1978 to include both the severance (mining) and processing of coal in Kentucky. Since 1981, other minerals and natural gas and natural gas liquids were subject to taxation under the Natural Resources Severance and Processing tax. The tax rate for both coal and natural resource severances has been 4.5% of gross value, though coal also has a minimum tax of fifty cents per ton. Transportation expenses and coal purchased for processing from a taxpayer registered for coal tax are deductible. Similar exemptions apply to the natural resources severance tax.[11]

Since 1992, 50% of revenues from both the coal and the natural resource severance taxes are allocated to local governments in the coal and mineral mining regions of eastern and western Kentucky.[12]

As *Table 2.10* shows, there is a great deal of variety among Kentucky and its competitor states in the products subject to severance or similar taxes as well as whether the tax is used at all. *Figure 2.11* shows the percentage of state tax revenue collected from severance taxes for 2011 for Kentucky, the United States, an average of its competitor states, and each competitor state. Some caution should be taken in interpreting as some states may collect revenues from natural resources, particularly timber, using property taxes based on value rather than severance taxes based on revenues. Still, the ranking of the states is not too surprising and reflects the importance of coal to the economy of Kentucky and West Virginia. In 2010, coal mining accounted for 8.37% of West Virginia's gross state product (GSP) and 2.43% of Kentucky gross state product.[13]

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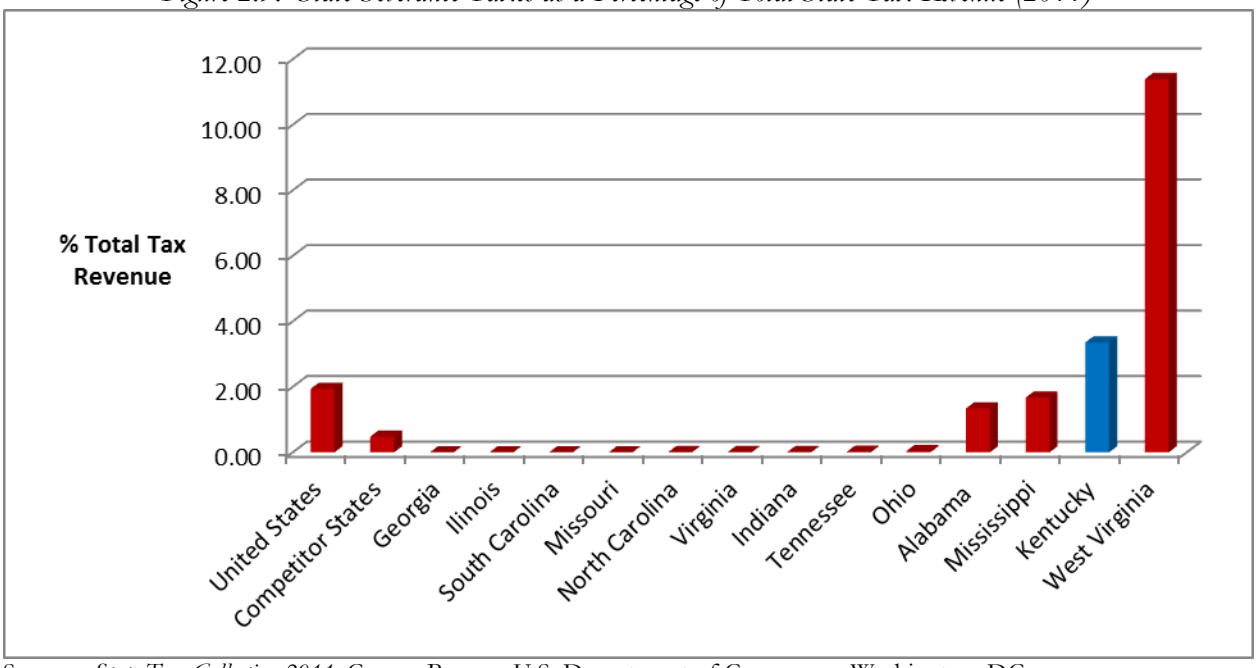
[11]From *Tax Expenditure Analysis: Fiscal Year 2012-2014,* Governor's Office for Economic Analysis, Office of the State Budget Director, Commonwealth of Kentucky.
[12]From Jason Bailey, *Promoting Long-Term Investment in Appalachian Kentucky: A Permanent Coal Severance Tax Fund,* Mountain Association for Community Economic Development (MACED)/Kentucky Center for Economic Policy (KCEP) (March 2012) (http://www.maced.org/files/MACED_Coal_Severance_Tax_Brief.pdf)
[13]Bureau of Economic Activity, Regional Data, GDP & Personal Income (http://www.bea.gov/iTable/iTable.cfm?ReqID=70&step=1).

Table 2.10: Severance Taxes Imposed by Kentucky and Competitor States

Alabama	Coal and lignite severance tax; Coal severance tax Forest products severance tax; Iron ore mining tax Local taxes; Oil and gas conservation and production tax Oil and gas production tax
Georgia	Tax on phosphates
Ilinois	Timber fee
Indiana	Petroleum production tax
Kentucky	Coal severance tax; Natural resource severance tax Oil production tax
Mississippi	Local taxes; Oil and gas severance tax; Salt severance tax Timber severance tax
Missouri	Assessment on surface coal mining permittees
North Carolina	Oil and gas conservation tax Primary forest product assessment
Ohio	Oil and Gas Marketing Program Assessment Resource severance tax
South Carolina	(No taxes imposed)
Tennessee	Coal severance tax; Local taxes; Oil and gas severance tax
Virginia	(No taxes imposed)
West Virginia	Severance taxes

Source: Judy Zelio and Lisa Hoiulihan, "State Energy Revenues Update," National Conference of State Legislatures, (2012)

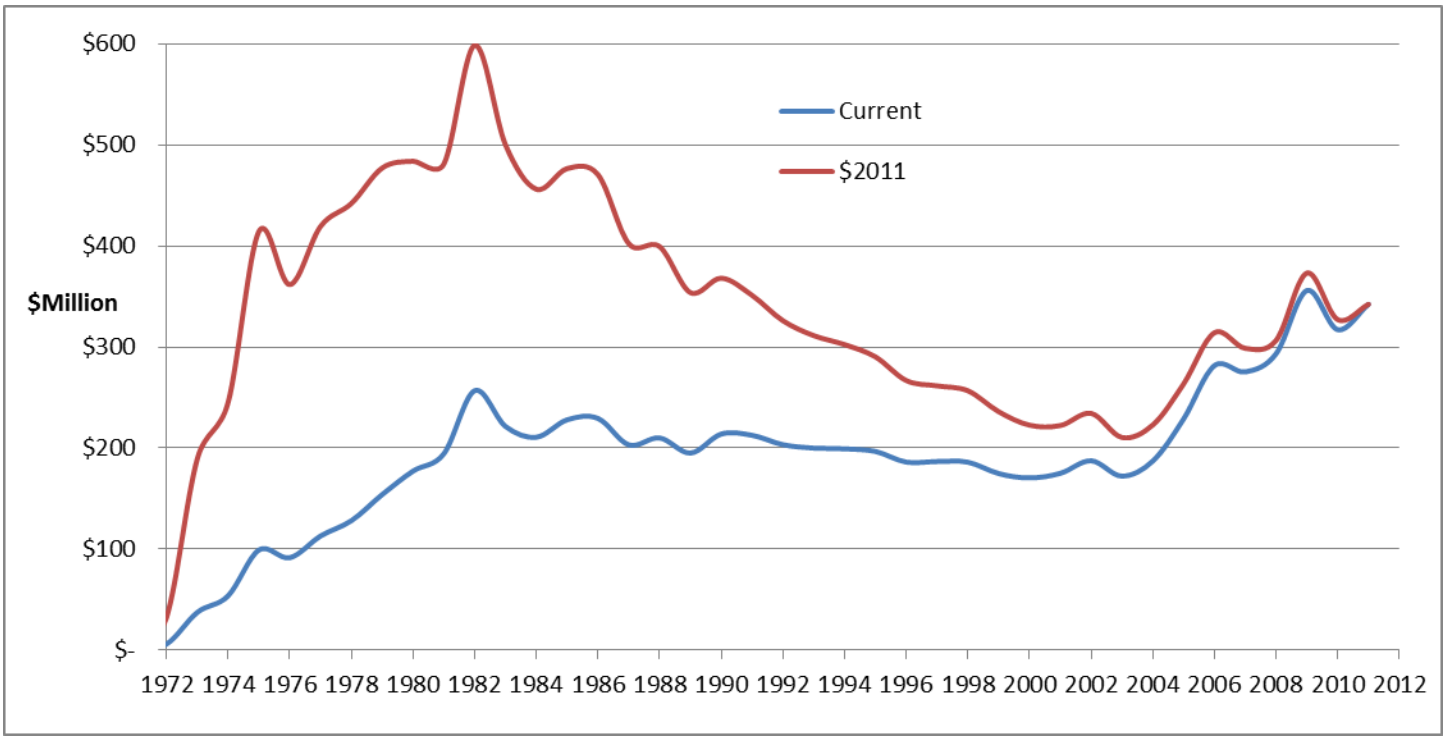
Figure 2.9: State Severance Taxes as a Percentage of Total State Tax Revenue (2011)



Source: *State Tax Collection 2011,* Census Bureau, U.S. Department of Commerce, Washington, DC.

Finally, *Figure 2.12* shows trends in severance tax revenue, both unadjusted (current) and adjusted for inflation ($2011). Most apparent from the figure is the variation in this revenue stream. The rapid increase in revenues from 1972 to 1978 reflects the inclusion of processing into the tax base. As the revenue is collected from an ad-valorem tax, total revenue depends on both quantity mined and processed and the price of coal. Hence much of the variation in this revenue stream reflects changes in coal prices and coal production in Kentucky.

Figure 2.10: Trends in Kentucky Severance Tax Revenues, Nominal and Real ($2011)



Source: State Government Tax Collections, various years, Census Bureau, U.S. Department of Commerce, Washington DC.

3. Adequacy and Elasticity

Kentucky faces a structural deficit that could reach $1 billion by 2020. Fundamental tax reform that improves the elasticity in the system—ensuring that tax revenues grow adequately with the economy—will go a long way toward solving Kentucky's structural deficit. Addressing this structural deficit promises to become more difficult in the future since the underlying economic, demographic, and political trends reducing elasticity are continuing and show no sign of abating.[14] Moreover, there are a number of financial factors likely to intensify state-level budgetary pressures in the future, such as Kentucky's $30 billion unfunded pension obligation[15] and long-term fiscal problems at the federal level.[16]

3.1 Kentucky's Structural Deficit

Revenue growth in Kentucky has slowed in the last several years, especially when compared to earlier periods. From 2000 to 2011, tax revenue failed to keep pace with the economy or declined more than the economy[17] in eight years while revenue growth exceeded economic growth in three years. Meanwhile, the demand for public services, such as education, health care, and infrastructure maintenance and development, continues, and can be expected to grow at about the same rate as the economy. If the revenue trend demonstrated from 2000 to 2008[18] continues to 2020, then state government would decrease to below 6.5 percent of the economy—a level not seen since 1968 when it was 5.9 percent.[19] By 2020, tax revenue would be more than a $1 billion short of expected demand for public services (see Figure 3.1).

There are three broad approaches that can be used to address the projected shortfall. First, the size of state government can be decreased. Second, higher tax rates can be implemented. Third, the elasticity can be increased so that revenues will grow with the economy. The third option, which typically entails lower rates and a broader base, is the preferred approach because it generally will lead to more robust growth in revenue as the economy grows.

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[14] For a comprehensive discussion of these issues see David Brunori, *State Tax Policy: A Political Perspective*, Third Edition (Washington, D.C.: The Urban Institute Press, 2011).

[15] "Kentucky legislative panel considers bond issue to shore up troubled pension systems," *Courier-Journal*, September 1, 2012.

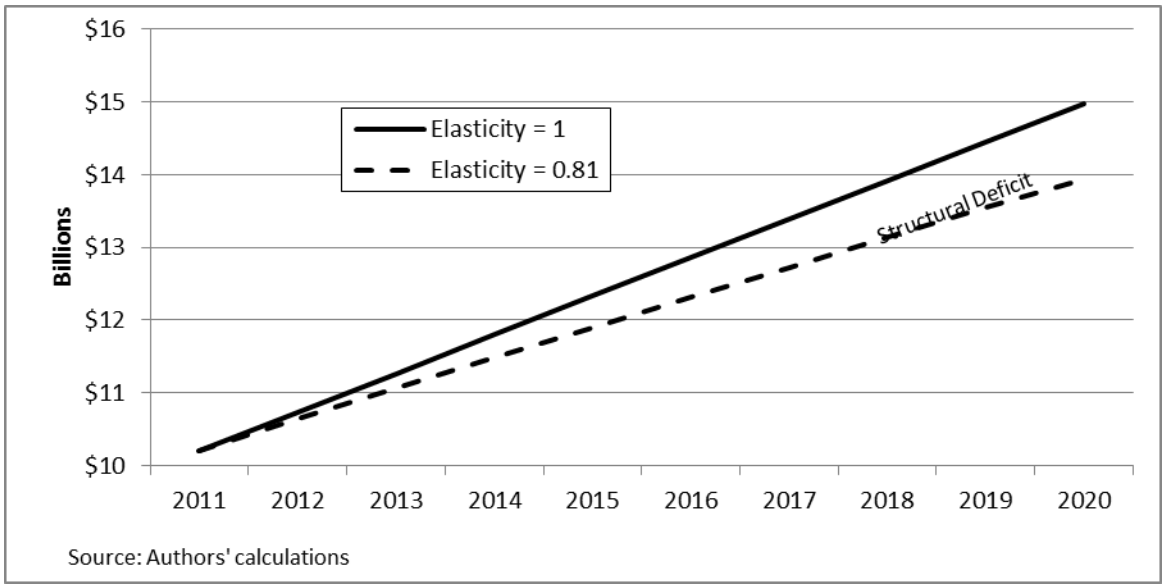
[16] *Report of the State Budget Crisis Task Force*, July 2012, available online at: www.statebudgetcrisis.org.

[17] Kentucky tax revenue declined by 3.1% and personal income declined by 1.2% in 2009—the trough year of the Great Recession.

[18] Given the extraordinary nature of the Great Recession in the late 1990s we do not include data from 2009-2011 in this analysis.

[19] In 1969 the size of state government (tax revenue) relative to the economy (personal income) jumped to 6.9 percent after the general sales tax was increased from 3 to 5 percent.

Figure 3.1: Simulated Kentucky Tax Revenue



3.2 Sufficient Revenue Growth

Kentucky's system of revenue should provide adequate resources to finance the services and investments that are deemed essential to a high quality of life. There are three aspects to adequately financing government: 1) revenues must finance the appropriate size of government based on the tastes and values of the citizens; 2) the structure must allow for acceptable funding across the business cycle; and 3) the revenue structure must allow financing to grow with the needs of the state so that the appropriate size government can be maintained over the long term.

Revenue or spending adequacy is a value-laden consideration that must be determined by policymakers and their constituents. There is no "right answer" that lends itself to a technical determination.[20] However, an appropriate pattern of revenue growth is the result of carefully crafted tax policy. Determining the correct size of government and then creating a revenue structure to change at approximately the same rate as the state's personal income—without the need to increase rates—should undergird this policy. This permits the desired size of government to be maintained in the future and allows state government tax financing to remain at a fixed percentage of the state's economy. Then, tax rates can be decreased whenever an explicit decision is made to reduce the size of government and increased only when an explicit decision is made to increase the size of government.[21] However, even the best designed tax policy will not produce revenues that will grow as fast as the economy in every year. It is nearly impossible to design a recession proof tax structure because nearly all taxes are ultimately levied on economic activity that is slowing in a recession. In recession years revenues can be expected to rise more slowly than income, but this should be offset by better revenue growth in expansion years, resulting in a system with the appropriate growth path over the long term. A rainy day fund can be used to smooth out the pattern of expenditures over the business cycle.

[20] Figures on expenditure comparisons and trends are found in the appendix.
[21] The only other time a major tax change should be needed is if a major structural change occurs in the tax system.

Adequate revenue growth is achieved by adopting the proper balance of revenue instruments. The more rapidly growing personal income tax must be balanced with the more moderately growing sales tax and the slow growing selective sales taxes to achieve the intended growth relationship with the economy. The required balance will depend on specific characteristics of the tax structure. For example, income taxes will generally grow faster relative to the economy when the structure is more progressive and sales taxes will grow more rapidly when broader taxation of services is adopted. Also, the balance of tax sources will need to vary with a state's economic structure—there is no single tax system that fits all states.

3.3 Recent Trends in State Tax Revenue

In the next section, we discuss, in detail, the relationship between growth in tax revenue and growth in the economy, the *elasticity* of the tax base—especially the two largest sources of tax revenue for Kentucky, the individual income tax and general sales tax. Here we provide a brief overlook of revenue growth for the past four to five years for Kentucky, its competitor states, and the average of state governments in the United States.

Table 3.1 summarizes annual changes, in percentage terms, for Kentucky, the average of all states (United States), the weighted- average[22] of all competitor states as well as each of the competitor states from fiscal year 2006 to 2011. Also reported is the change in revenue from 2007 to 2011. These revenue changes are nominal dollars, not adjusted for inflation. They are also not adjusted for changes in tax rates and policies, though the table notes any changes in the two major sources of tax revenue for state governments, the personal income tax and the sales tax.

Table 3.1: Annual Changes State Tax Revenue[1]

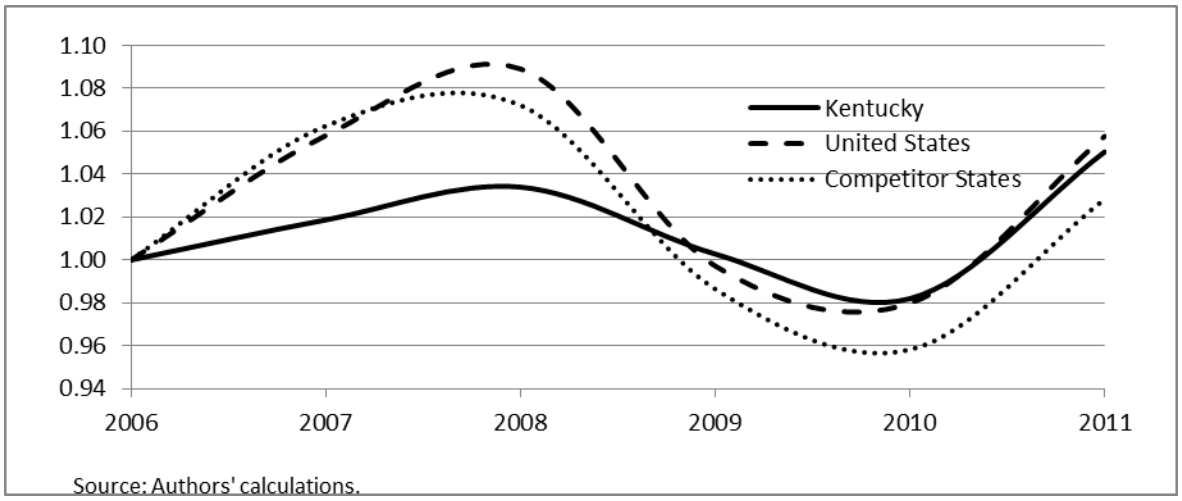
	% Change in State Tax Revenue					
State	'07 – '11	'06 – '07	'07-'08	'08-'09	'09-'10	'10-'11
Kentucky	**3.1**	**1.9**	**1.5**	**-3.0**	**-2.1**	**7.0**
United States	**0.0**	**5.8**	**2.9**	**-8.4**	**-1.7**	**7.9**
Competitor States	**-3.2**	**6.2**	**0.9**	**-8.0**	**-2.9**	**7.3**
Alabama	**-2.6**	4.0	2.3	-8.4	1.1	2.8
Georgia	**-12.3**	7.2	-1.0	-11.0	-8.1	8.3
Ilinois[3]	**-2.1**	7.2	-0.5	-8.4	-6.9	15.3
Indiana[2]	**5.0**	4.2	6.5	-1.4	-7.4	8.1
Mississippi	**3.6**	8.2	4.1	-3.8	-3.4	7.1
Missouri	**-5.6**	5.2	2.0	-5.9	-5.6	4.2
North Carolina[2]	**-0.9**	9.8	0.9	-10.0	4.8	4.1
Ohio[3]	**-2.0**	1.1	1.5	-8.3	-1.4	6.8
South Carolina[2,3]	**-11.5**	12.0	-2.9	-9.5	-4.2	5.1
Tennessee	**-4.7**	6.8	1.3	-9.6	0.8	3.3
Virginia	**-6.7**	8.0	-1.8	-9.4	-1.2	6.1
West Virginia	**10.8**	2.1	5.2	-1.9	-0.3	7.8

[1]Nominal dollars not adjusted for inflation. Source: Survey of Government Finances, U.S. Bureau of Census.
[2]These states changes sales tax rates during the period 2006 – 2012.
[3]These states made significant modifications to their personal income tax during the period 2006 – 2012.

[22]Again, the weight in this average is state tax revenue.

As can be seen from *Table 3.1,* Kentucky has had much less variance in its tax revenue than many of its competitor states. This can be seen more clearly in *Figure 3.2* which compares state tax revenue in 2007 to 2011 relative to 2006. While the peak of revenue in 2008 was much less pronounced for Kentucky with approximately a 3.5% increase relative to 2006 than its competitors (8 %) and the U.S. average (9 %), it only saw a 2 % reduction in 2010 relative to 2006. In contrast, revenues fell by over 4% for its competitor states and slightly over 2% on average for the U.S.

Figure 3.2: Growth in State Tax Revenue, 2006-2011



3.4 Kentucky's Revenue Elasticity

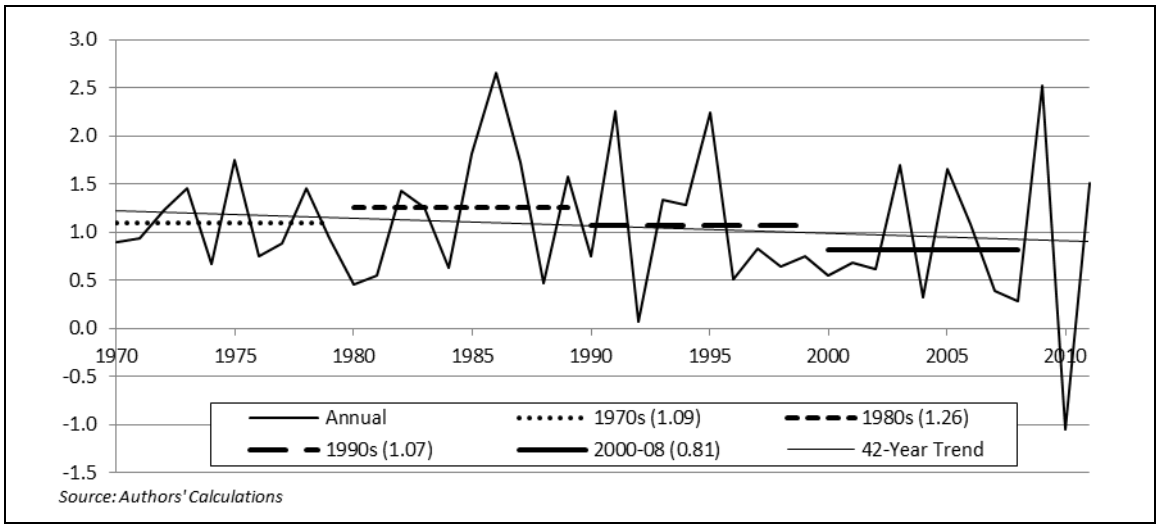
Kentucky's recurring budgetary problems are due, in part, to the long-term decline in revenue elasticity—a measure of whether revenue is keeping pace with the economy.[23] There are several economic, demographic, and political factors contributing to the gradual reduction in elasticity. A multitude of systemic factors affect these sources of revenue, including the gradual shift in personal income away from taxable sources (e.g., wages, salaries, and proprietors' income) and toward mostly nontaxable sources (e.g., some transfer payments and nontaxable employee benefits); the transition from a goods-producing economy that is taxed to a service-providing economy that is largely untaxed; the rise of "mail order" or remote retail sales, which includes Internet and catalog purchases; an aging population whose spending patterns generate less revenue compared to younger cohorts; and the prevalence of tax exemptions. Given the systemic nature of these changes, the long-term decline in revenue elasticity will likely continue in the absence of tax reform.

Here, we do not assess whether government spending is too high or too low, or if the size of government is too big or too small. If policymakers desire government spending to remain approximately proportional to the size of the economy, then revenue elasticity determines whether sufficient revenue is available to do so without frequent increases in tax rates. This analysis illustrates the long-term decline of Kentucky's revenue elasticity and compares it to other states.

[23] Revenue elasticity is calculated as the percent change in revenues divided by the percent change in personal income. An elasticity of 1.0 indicates that revenue is growing at the same rate as the economy, an elasticity of less than 1.0 means revenues grow more slowly than the economy, and an elasticity of greater than 1.0 means revenues grow more rapidly than the economy.

While year-to-year volatility is typical, over the long term revenue should change at approximately the same rate as the economy if the demand for government services and activities is more or less proportional to personal income. An elasticity of 1.0 indicates that revenue growth is keeping pace with economic growth, while an elasticity of less than 1.0 shows revenue is growing slower than the economy. The average elasticity in the 1970s, 1980s, and 1990s are 1.09, 1.26, and 1.07 respectively, but revenue elasticity declines to 0.81 from 2000 to 2008 (see Figure 3.3). The 42-year trend illustrates the downward slope of elasticity.

Figure 3.3: Kentucky's Revenue Elasticity, 1970 to 2011



The same general pattern holds true for the state's two largest sources of tax revenue, the sales and income taxes. As shown in Table 3.2 there has been a general reduction in revenue elasticity since 2000 in the individual income and general sales tax.

Table 3.2: Kentucky Revenue Elasticity

Period	Total Tax Revenue	Individual Income Tax Revenue	General Sales Tax Revenue
1970 - 1979	1.09	1.39	0.84
1980 - 1989	1.26	1.56	1.05
1990 - 1999	1.07	1.63	1.00
2000 - 2008	0.81	0.82	0.87

Source: Authors' calculations.
Note: The total tax revenue and general sales tax revenue were adjusted for the sales tax increase from 5 to 6 percent that occurred in 1991.

Finally, it is also worth noting that a more elastic revenue system means that with downturns in the economy contractions in revenue are larger. Thus elasticity and stability may, at times, be two conflicting goals for a revenue system.

3.5 Comparing Kentucky to Competitor States

Revenue growth rates are affected by both changes in the revenue base and tax rates. Many states' revenue systems have failed to keep pace with overall economic growth during the past decade due to one or both of these factors. Using the ratio between the compound annual growth rates (CAGR) of revenue and personal income, we compare Kentucky to competitor states during three time periods—1980 to 1989, 1990 to 1999, and 2000 to 2008.[24] Just like revenue elasticity, a ratio of 1.0 indicates that the revenue is growing at the same rate as the economy. Below we examine total taxes, the individual income tax, and the general sales tax.

3.5.1 Total Taxes

In Kentucky as well as in many of the competitor states the growth in total tax revenue has slowed relative to the economy in recent years. As shown in Table 3.3, the ratio between Kentucky's total tax CAGR and personal income CAGR declined to 0.81 during the most recent period (2000-2008). By comparison, this ratio was 1.1 and 1.02 in the earlier periods. The ratio also declined for the competitor state average—from 1.02 to 0.86. During the 2000-08 period, four of the competitor states—Georgia, Missouri, South Carolina, and Virginia—have ratios lower than Kentucky's, while the remaining 12 competitor states have ratios higher than Kentucky's.

Table 3.3: Compound Annual Growth Rates (CAGR), Personal Income and Total Tax Revenue, Kentucky and Competitor States, Various Time Periods

	1980 - 1989			1990 - 1999			2000 - 2008		
	Total Tax	Personal Income	Ratio	Total Tax	Personal Income	Ratio	Total Tax	Personal Income	Ratio
Kentucky	**7.4%**	**6.7%**	**1.10**	**5.7%**	**5.6%**	**1.02**	**3.4%**	**4.2%**	**0.81**
Competitor States	**7.8%**	**7.6%**	**1.02**	**5.7%**	**5.8%**	**0.98**	**3.8%**	**4.5%**	**0.86**
Alabama	7.8%	7.7%	1.02	5.2%	5.4%	0.96	4.4%	5.2%	0.85
Georgia	9.6%	9.8%	0.98	6.5%	7.3%	0.89	3.7%	4.8%	0.78
Illinois	5.0%	6.7%	0.75	5.0%	5.3%	0.95	3.5%	4.0%	0.87
Indiana	8.0%	6.7%	1.19	5.3%	5.5%	0.98	3.8%	3.7%	1.02
Missouri	8.1%	7.3%	1.11	6.3%	5.5%	1.15	3.1%	4.6%	0.67
Mississippi	5.9%	6.9%	0.86	6.6%	6.2%	1.06	4.6%	5.1%	0.90
North Carolina	9.7%	9.4%	1.03	6.3%	6.9%	0.91	4.9%	5.0%	0.98
Ohio	8.7%	6.5%	1.34	5.3%	4.8%	1.10	3.2%	3.2%	1.01
South Carolina	8.3%	8.8%	0.95	5.1%	6.0%	0.85	2.7%	5.0%	0.55
Tennessee	7.6%	8.1%	0.94	5.5%	6.5%	0.84	4.0%	4.7%	0.85
Virginia	9.9%	9.2%	1.08	6.4%	5.7%	1.13	4.4%	5.7%	0.78
West Virginia	3.2%	4.9%	0.66	4.5%	4.4%	1.01	4.8%	4.6%	1.05

Source: Authors' calculations
Note: CAGR was calculated on current dollars. Adjustments were made to reflect changes in the sales tax rates.

3.5.2 Individual Income Tax

As shown in Table 3.4, the ratio between Kentucky's individual income tax CAGR and personal income CAGR declined significantly in the most recent period (2000-2008) compared to earlier

[24] We do not include the years during the most recent recession 2009-2011) since the income and revenue trends evidence

periods. And while this ratio also declined for the competitor states too—from 1.53 to 0.94—it is much closer to 1.0 compared to Kentucky's (0.77). There is only one state in the most recent time period with a ratio lower than Kentucky's, Ohio with a ratio of 0.71.

Table 3.4: Compound Annual Growth Rates (CAGR), Personal Income and Individual Income Tax Revenue, Kentucky and Competitor States, Various Time Periods

	1980 - 1989			1990 – 1999			2000 - 2008		
	Individual Income Tax	Personal Income	Ratio	Individual Income Tax	Personal Income	Ratio	Individual Income Tax	Personal Income	Ratio
Kentucky	**9.1%**	**6.7%**	**1.36**	**8.5%**	**5.6%**	**1.53**	**3.2%**	**4.2%**	**0.77**
Competitor States	**11.6%**	**7.6%**	**1.53**	**7.0%**	**5.8%**	**1.22**	**4.2%**	**4.5%**	**0.94**
Alabama	11.6%	7.7%	1.50	6.1%	5.4%	1.12	5.1%	5.2%	0.98
Georgia	13.5%	9.8%	1.38	7.9%	7.3%	1.09	4.2%	4.8%	0.88
Illinois	7.1%	6.7%	1.06	6.0%	5.3%	1.14	3.8%	4.0%	0.96
Indiana	14.9%	6.7%	2.23	6.6%	5.5%	1.20	3.2%	3.7%	0.86
Missouri	12.1%	7.3%	1.66	8.2%	5.5%	1.49	4.7%	4.6%	1.02
Mississippi	11.5%	6.9%	1.67	9.6%	6.2%	1.55	5.6%	5.1%	1.09
North Carolina	11.0%	9.4%	1.18	7.7%	6.9%	1.11	5.4%	5.0%	1.09
Ohio	15.5%	6.5%	2.37	6.4%	4.8%	1.32	2.3%	3.2%	0.71
South Carolina	10.8%	8.8%	1.24	5.8%	6.0%	0.97	3.9%	5.0%	0.78
Tennessee	13.4%	8.1%	1.65	5.0%	6.5%	0.77	6.2%	4.7%	1.32
Virginia	12.2%	9.2%	1.32	7.9%	5.7%	1.39	5.0%	5.7%	0.88
West Virginia	7.1%	4.9%	1.45	6.6%	4.4%	1.50	5.8%	4.6%	1.26

Source: Authors' calculations
Note: CAGR was calculated on current dollars and no adjustments were made to the individual tax revenue.

3.5.3 General Sales Tax

The ratio between Kentucky's general sales tax CAGR and personal income CAGR declined slightly from the earlier period to the most recent period, with a similar pattern evidenced by the competitor state average. North Carolina is the only competitor state with a ratio in the most recent time period (2000-2008) closer to 1.0 then Kentucky—0.95 compared to Kentucky's 0.85 and the competitor state average of 0.61.

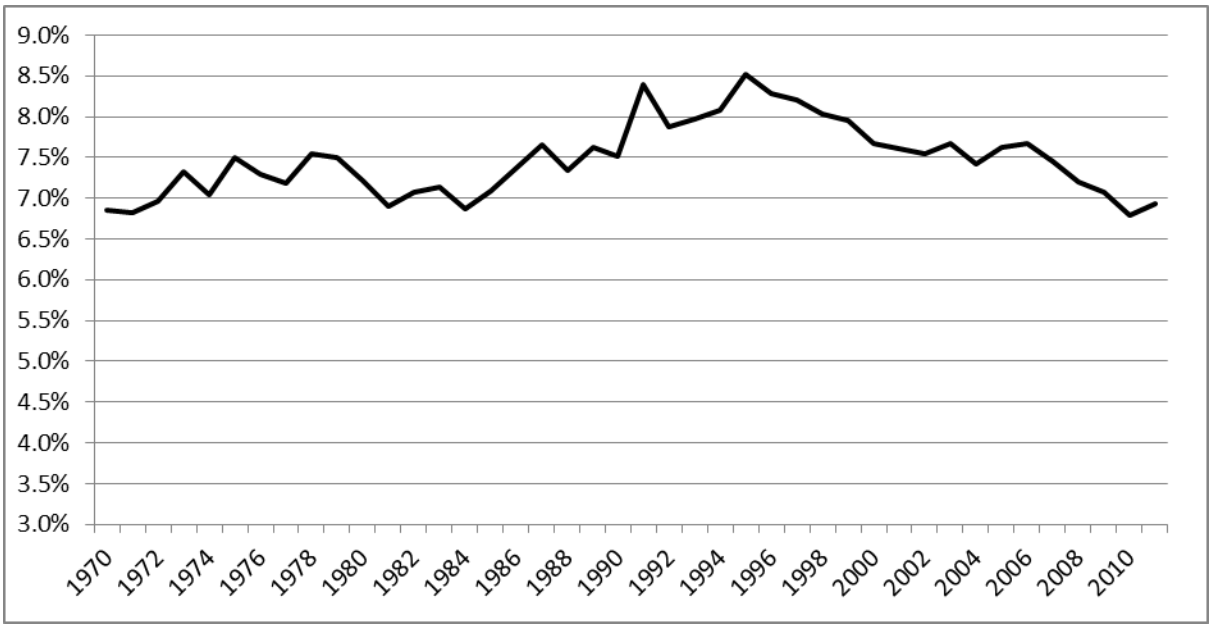
Regardless of whether we assess the adequacy of the revenue structure by comparing average elasticity or the CAGR ratio, Kentucky's main revenue sources are growing slower than its economy. While the average elasticity in the earlier periods has been about 1.0, it has slowed to 0.81 from 2000 to 2008. This point is also illustrated by examining Kentucky's total tax collections as a percentage of personal income (see Figure 3.4), which has declined steadily from its peak of 8.52% in 1995 to 6.94% in 2011. A continuation of this trend could seriously hinder Kentucky's ability to deliver quality education, health, and other public services.

TABLE 3.5: Compound Annual Growth Rates (CAGR), Personal Income and General Sales Tax Revenue, Kentucky and Competitor States, Various Time Periods

	1980 - 1989			1990 - 1999			2000 - 2008		
	General Sales	Personal Income	Ratio	General Sales	Personal Income	Ratio	General Sales	Personal Income	Ratio
Kentucky	**6.2%**	**6.7%**	**0.92**	**5.3%**	**5.6%**	**0.96**	**3.6%**	**4.2%**	**0.85**
Competitor States	**5.7%**	**7.6%**	**0.74**	**4.5%**	**5.8%**	**0.79**	**2.7%**	**4.5%**	**0.61**
Alabama	6.1%	7.7%	0.79	5.3%	5.4%	0.97	3.8%	5.2%	0.73
Georgia	8.4%	9.8%	0.85	5.7%	7.3%	0.78	2.8%	4.8%	0.60
Illinois	3.1%	6.7%	0.46	1.7%	5.3%	0.33	2.7%	4.0%	0.69
Indiana	5.0%	6.7%	0.75	2.9%	5.5%	0.54	2.2%	3.7%	0.58
Missouri	5.7%	7.3%	0.78	4.1%	5.5%	0.74	1.9%	4.6%	0.41
Mississippi	2.9%	6.9%	0.42	6.5%	6.2%	1.04	3.8%	5.1%	0.74
North Carolina	10.5%	9.4%	1.12	3.9%	6.9%	0.57	4.7%	5.0%	0.95
Ohio	7.4%	6.5%	1.13	5.6%	4.8%	1.17	1.7%	3.2%	0.52
South Carolina	7.2%	8.8%	0.82	5.5%	6.0%	0.92	0.4%	5.0%	0.08
Tennessee	7.2%	8.1%	0.88	5.7%	6.5%	0.88	3.5%	4.7%	0.75
Virginia	7.1%	9.2%	0.77	6.5%	5.7%	1.16	3.0%	5.7%	0.52
West Virginia	-7.8%	4.9%	-1.58	1.8%	4.4%	0.41	2.4%	4.6%	0.52

Source:Authors' calculations
Note: CAGR was calculated on current dollars and adjustments were made to reflect changes in the sales tax rates.

Figure 3.4: Kentucky Total Tax Collections as a Percentage of Personal Income, 1970-2011



3.6 Simulation of Future Revenue Performance

We simulate Kentucky revenue to 2020 using two different assumptions. In the first scenario we assume that tax revenues will grow at the same rate as the economy—which was the case, more or less, in the 1970s, 1980s, and 1990s. Then, in the second scenario we assume that revenue will grow at the same elasticity that occurred from 2000 to 2008. The second scenario is more likely since the trends, factors, and forces that have been reducing revenue elasticity are still in place and are

expected to remain for the foreseeable future. In both scenarios we assume that Kentucky's economy will grow at the compound annual rate of 4.2 percent, which is the rate experienced from 2000 to 2008.

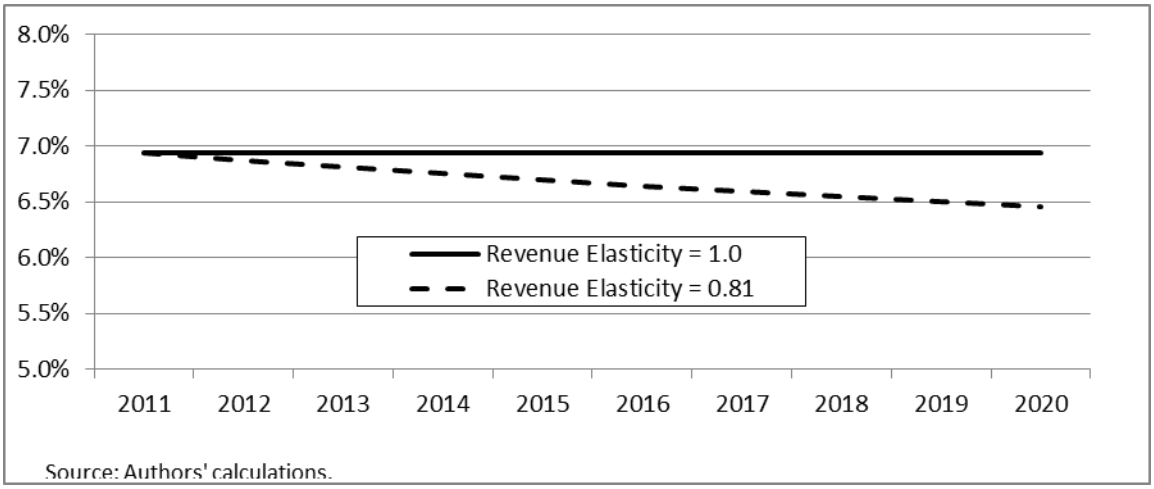
Total tax revenue grows in both scenarios—as does Kentucky's economy—but the size of state government, as well as its ability to deliver services, is markedly lower in the second scenario given the expected annual shortfalls (see Table 3.6). Tax revenue remains at about 6.9 percent of the economy in the first scenario but declines to below 6.5 percent in the second scenario (Figure 3.3). As we indicated earlier, this represents a size of state government that has not been seen since 1968. If revenue elasticity is not improved, then tax revenue would be more than a $1 billion short of expected demand for public services by 2020, resulting in a significant reduction in the size of government. Addressing this structural deficit by improving revenue elasticity is necessary for the long-term finance of Kentucky state government services and investments. In the sections that follow we present options that will improve the elasticity of Kentucky's tax structure.

Table 3.6: Kentucky Revenue Simulation

	Revenue (Elasticity = 1.0) ($millions)	**Revenue (Elasticity = 0.81) ($millions)**	**Shortfall ($millions)**
2013	$ 11,265	$ 11,059	($ 206)
2014	$ 11,796	$ 11,481	($ 314)
2015	$ 12,327	$ 11,900	($ 427)
2016	$ 12,858	$ 12,315	($ 543)
2017	$ 13,389	$ 12,727	($ 662)
2018	$ 13,919	$ 13,136	($ 784)
2019	$ 14,450	$ 13,541	($ 909)
2020	$ 14,981	$ 13,944	($ 1,037)

Source: Authors' calculations.

Figure 3.5: Simulated Kentucky Tax Revenues as a Percentage of Personal Income



4. Fairness and the Distribution of Tax Burden

4.1 Principles of Fairness

The notion of a tax system being "fair" or "unfair" is clearly a subjective notion and therefore not a topic in which we or any other economists have any expertise. Thus, rather, than evaluating whether or not the Kentucky tax system is fair or not fair, our objective here is to provide some information about the distributional impact of Kentucky's tax system -- that is, who appears to be bearing the burden of Kentucky's taxes.

Rather than attempting to discuss the distribution of the tax burden for the system as a whole, as has been done by a number of studies, we focus on the distribution of the burden for individual taxes instruments. We do this for two reasons: 1) the studies that attempt to examine the burden of the entire system often have to make rather heroic assumptions about the incidence of taxes; and 2) as the policy recommendations that we make are about options for specific tax instruments, we believe it is more useful to have an understanding of the distributional impact of those taxes might be.

Before discussing the distribution impacts of Kentucky's current tax structure it will be useful to discuss a few considerations when discussing the fairness and distribution of taxes.

4.1.1 Vertical Equity

The notion of *vertical equity* can best be summarized as justice or fairness of different individuals or households in different economic circumstances. In practice, vertical equity is most often focused on the relative tax burden of households having different incomes. However, there are other senses in which households are in different economic circumstances and many may view it as fair to treat them differently. Obvious examples are exemptions based on the number of dependents or treatment of different sources of incomes, for example, pensions or capital gains, differently.

Tax systems in which households with lower incomes pay a greater share of their income in taxes are referred as *regressive*; when taxes as a share of income are higher in households with greater incomes that tax is considered *progressive*. Finally, if taxes as a share of income are the same for households of low and high incomes, the system is *proportional*.

4.1.2 Horizontal Equity

Less attention has probably been paid by policymakers to notion of *horizontal equity*, fairness in the treatment of individuals or households in similar economic circumstances. At one extreme, horizontal equity might be considered having households with the same income paying the same in taxes.

If this is the notion of equal economic circumstances, current tax policies, for all states and all levels of government, violate this notion. For income taxes the source of income broadly defined -- earnings, pensions, health insurance, capital gains, social security, and in-kind transfers are clearly treated differently resulting in differences in tax payments. Then, too, deductions and exemptions result in different taxes for households with the same incomes. Thus, for example, two households with the same incomes but one that owns their house and has a mortgage and the other that rents

have potentially very different income tax burdens. These two households have made different consumption choices but are their economic circumstances different?

Taxes on consumption, a general sales tax and excise taxes on specific goods, for example, mean that consumption choices rather than what we might consider economic circumstances such as income. Differences in tax burden from sales taxes are likely to be more pronounced the narrower the tax base and the higher the rate on the base. A very broad base, including tangible goods and services, for example, with a lower tax rate, is likely to result in smaller differences in tax burden for households of similar incomes.

4.1.3 Incidence

Critical to understanding the fairness of a tax is determining who really pays the tax. Economists make the distinction between *statutory incidence*, from whom the tax is collected, and the *economic incidence*, who actually pays the tax. Thus, for example, the statutory incidence of a tax on retail gasoline purchase is with the station selling the gasoline but if the price of gasoline inclusive of the tax is higher to the consumer purchasing the gasoline then at least part of the economic incidence is borne by the consumer.

Economic research suggests that the burden of the sales and excise taxes is borne by consumers – that is, the final price of goods that includes taxes increase by the amount of the taxes.[25] The evidence on the impact of taxes on earnings, such as payroll taxes, suggests that the burden is borne by the employee.[26] Higher taxes on earnings results in lower earnings. Thus the notion that an employer pays half of OASDI (Social Security) and Medicare taxes is not, in terms of economic incidence, accurate as this increase in tax burden on employer is likely to result in lower wages or growth in wages. It should, however, be noted that for imposition of state and local taxes on earnings, economic research suggests that the burden is not fully borne by employees.

Perhaps one of the most important implications of the distinction between statutory and economic incidence applies to taxation of businesses. Businesses do not bear any of the burden of taxation, taxes imposed on businesses are ultimately borne by the consumers of the goods and services they produce, their employees, or the owners and investors in the business. However, while it is tempting to think that the incidence of taxes imposed on businesses located in Kentucky but selling their goods and services elsewhere will be borne by their consumers elsewhere, this is likely not to be the case. If the business is in a competitive industry, with its competitors located in other states and nations, differences in Kentucky taxes are likely to be borne in Kentucky as lower earnings to employees and rents.

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[25] See Timothy Besley and Harvey S. Rosen. "Sales Taxes and Prices: An Empirical Analysis," *National Tax Journal* (1999) and J. Poterba. "Lifetime Incidence and the Distributional Burden of Excise Taxes," *American Economics Review* (1989)for studies of the incidence of state sales taxes. Both studies find that the burden of a general sales tax is borne almost entirely by final consumers of the taxed goods.

[26] See Sally Wallace "The Effects of State Personal Income Tax Differentials on Wages," *Regional Science and Urban Economics, (1993).* Wallace examines the extent to which the incidence of state income taxes are fully borne by the employee in eight sectors of the economy. She finds that labor does not bear the full burden of the income tax in 25% of the occupation/industry groups she examines.

4.2 Limits of Redistribution and the Level of Government

The effectiveness of redistribution, either through the tax code or through transfer programs, depends on both the responses of the recipients of the assistance and the taxpayers financing the programs. For state and local governments attempting to engage in redistribution through the tax code or transfer programs, the responses of greatest concern are the mobility of taxpayers and recipients of aid. In the economic literature, there has been a great deal of research examining how differences among states in welfare programs influence the location of households eligible for this aid. Results of these studies suggest that states with more generous transfer programs may attract recipients from other states. While the mobility of low income households may be of some concern in the design of transfer programs, this is probably less of a concern in designing a tax system.

On the other end, there is evidence that higher income and other taxes influence the locational decisions of households. Coomes and Hoyt (2008)[27] examine how differences in state income taxes influence locational decisions of households living in metropolitan areas on state borders (Louisville and Cincinnati as examples) and find that households are more likely to choose to live in the state with the lower taxes everything else equal, though the impact is relatively small.

Because it is much less costly for households and businesses to relocate between states or localities than it is for them to relocate between countries, states and localities have much less ability to redistribute income than the federal government does. Offering aid programs that are much more attractive than neighboring states is likely to induce migration of eligible households into the state increasing the costs of operating the programs. At the other end, high marginal income tax rates make the state less attractive to high income individuals and the firms that employ them. While redistribution by state governments is possible, the federal government, because of the very limited mobility at this level, is going to be much more effective at redistribution.

4.3 Distributional Impact of Sales Tax

As discussed in the preceding section, economists believe, with supporting evidence that sales taxes are borne by the consumer not the producer or retailer. Then to understand how the sales tax burden varies with income, we need information about household expenditures for households with different incomes. This is obtained from the Consumer Expenditure Survey (CE), a survey of households undertaken by the United States Bureau of Labor Statistics (BLS).[28] Each of the households in the survey completes a detailed diary of their purchases and expenditures during the survey period. Among other summary data the BLS releases from this survey is detailed information of the expenditure patterns by level of income.

This table is the basis for our examination of the burden of the Kentucky state sales tax on households of different income levels. A few points of caution about this analysis are worth bearing in mind. First, as discussed earlier, this analysis is done assuming the incidence of sales tax is entirely borne by the final consumer. Second, this is analysis of *direct* sales taxes to the consumer, that is, sales taxes on final retail transactions of goods and services. In fact, as Ring (1999) has estimated

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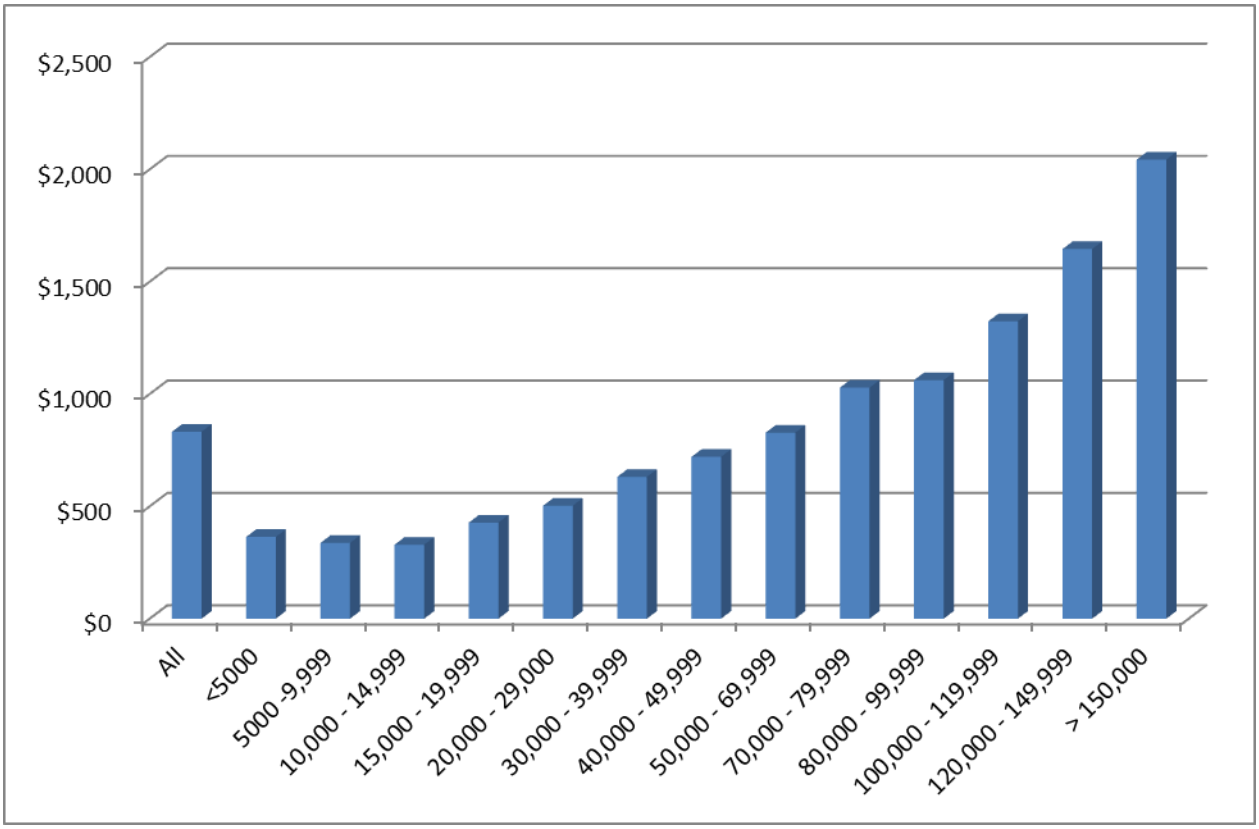
[27]Pual A. Coomes and William H. Hoyt, "Income taxes and the destination of movers to multistate MSAs, *Journal of Urban Economics* (2008).

[28] See the Bureau of Labor Statistics website discussion of the Consumer Expenditure Survey at http://www.bls.gov/cex/ for more detail on the survey.

and as is clear from Kentucky statutes, a major share of the general sales tax collections are not on final sales but intermediate business-to-business transactions.[29] We make no attempt to estimate the final incidence of these *indirect* sales taxes on consumers. Further, these expenditure estimates are based on a sample of households across the entire United States rather than just Kentucky as the BLS will not release that refined of information on geographical location in this survey. While there are obvious differences among states and regions in consumption patterns, it is not obvious that expenditure patterns in Kentucky will vary much from the United States average. Finally, within each income category, these are the average expenditures – individual households with the expenditure category may have very different spending patterns.

Then having information about the expenditure patterns of households in different income ranges enables us to determine what the average sales tax burden of these households are. We do this by matching information about the goods and services subject to the Kentucky sales tax with our information on household expenditures. The sales tax burden, then, is six percent of whatever expenditures are subject to taxation. In *Figure 4.1A* we report the average direct Kentucky general sales tax payments for 2010.

Figure 4.1A: Estimated Direct Kentucky Annual General Sales Tax Burden by Income, Current Code



Source: Authors' calculations using the Consumer Expenditure Survey prepublication tables (courtesy Bureau of Labor Statistics), and information on goods and services subject to the Kentucky general sales tax from http://www.lrc.ky.gov/kar/TITLE103.HTM and discussion with Department of Revenue personnel.

[29]Raymond Ring, Jr. "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal* (1999) estimates that only 54 percent of the general sales tax in Kentucky 1989 was directly paid by consumers.

Perhaps more relevant for discussions of tax distribution is a comparison of the share of income paid in sales taxes for the different levels of income. This can be seen in *Figure 4.1B* where the redline shows the tax paid by the household of average income in the sample.[30]

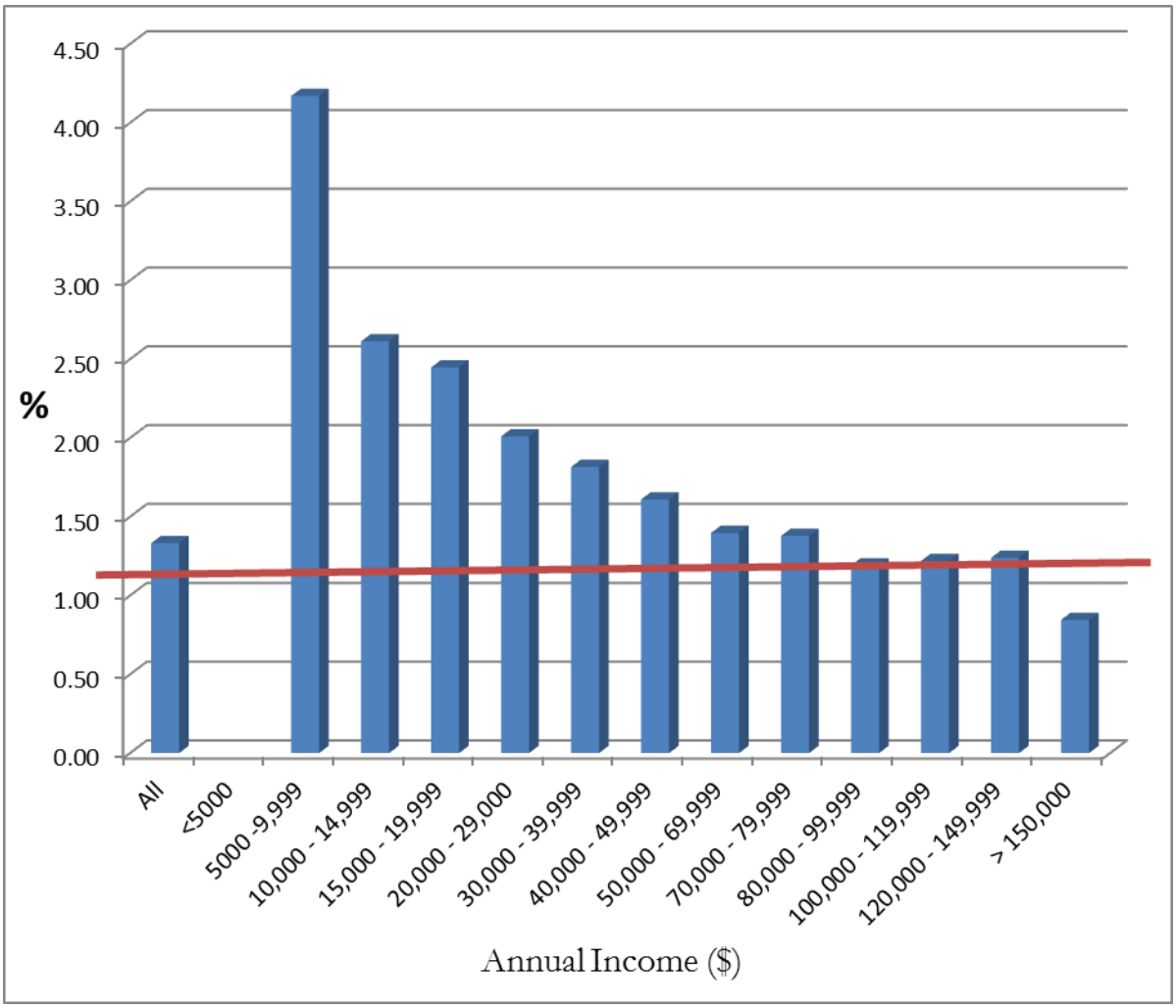
As the figure makes clear, the general sales tax is regressive – households with lower incomes pay, on average, a greater share of their income in direct general sales taxes than households with higher incomes. Why is this? There are two reasons. One is that the current tax base, focused on tangible goods rather than services, might be one that lower income households spend a disproportionate share of their income on. The second is that lower and higher income households differ in how much of their income they spend. While there is some evidence that the first explanation might have some merit, it is only limited as Kentucky does not have a general sales tax on food nor most shelter. There is far more evidence to suggest that the differences in expenditures as a share of income explains much more of the difference. On average, households with annual gross income below $40,000 have expenditures exceeding income while households with incomes exceeding $100,000 spend less than 70% of their income on average.

To give some perspective on how differences in the sales tax base affect direct tax burdens and the distribution of taxes, we offer two alternative options. While we discuss these options more later, the first option is to expand the base by adding a number of consumer services primarily household services (cleaning), automotive, and personal care (barber, stylist, health club) to the current general sales tax base. In addition, we impose a three percent tax on utilities (already subject to a local maximum of rate of three percent). The second option adds food purchased for home consumption not already subject to taxation to the current base and the base added in the first option. *Figure 4.2A* shows the estimated tax burden for the different levels of income for the current code and these two additional options and *Figure 4.2B* gives the tax burden as a percentage of income.[31]

[30] In *Figure 4.1B* (as well as *Figure 4.2B)* taxes paid as a percentage of income is based on the average income within that income bracket -- this is not the midpoint of the bracket and, in fact, for households with income less than $5,000, this figure was negative and why nothing is reported. *Table A.4.1* in the Appendix reports the average income for each income bracket.

[31]Estimated food stamp income was subtracted from food expenditures when making the calculations reported in *Figure 4.3* and *Figure 4.4* as these purchases would not be subject to taxation.

Figure 4.1B: Estimated Direct Annual Sales Tax Burden as Percentage of Income by Income, Current Code

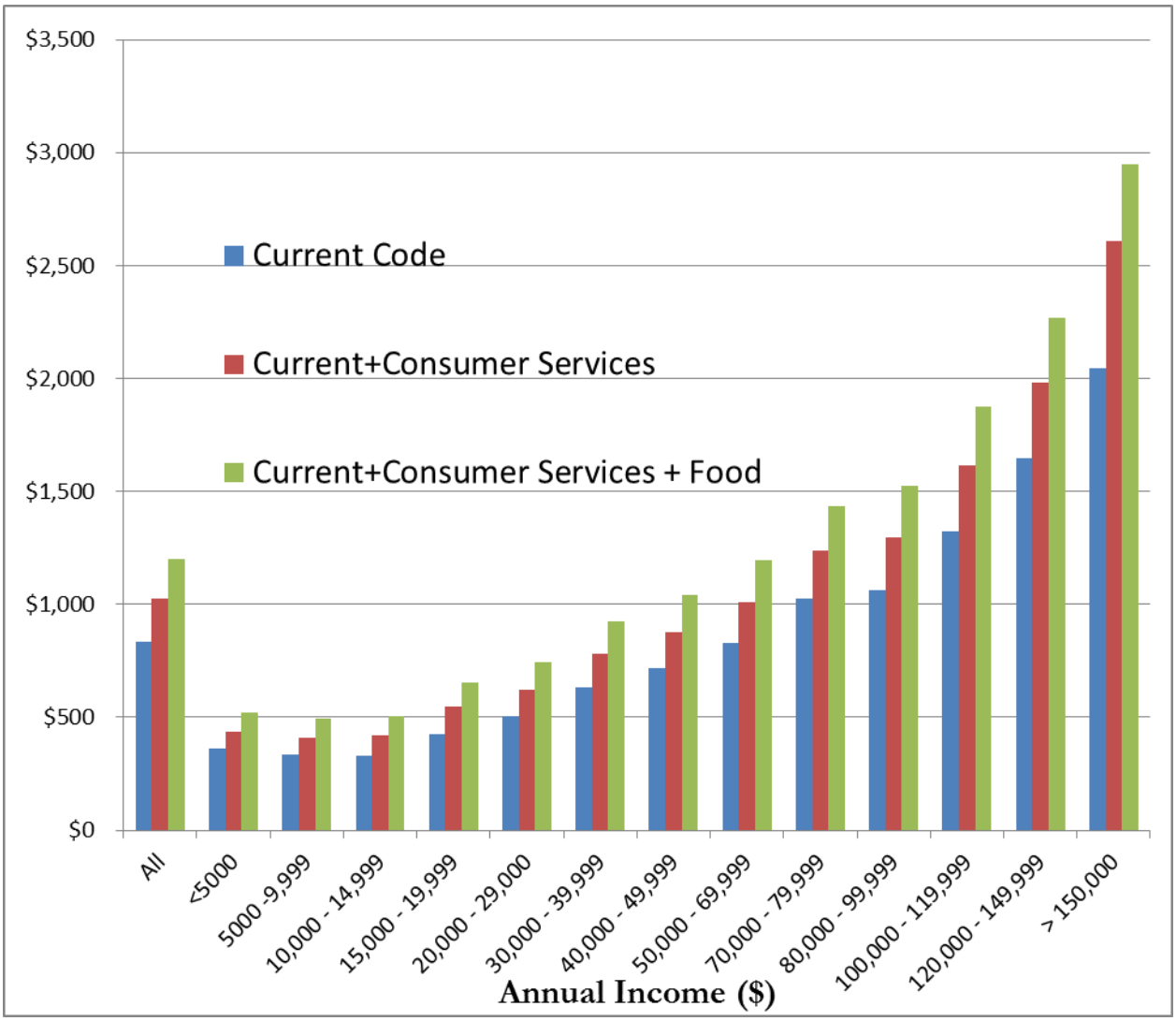


Source: Authors' calculations using the Consumer Expenditure Survey prepublication tables (courtesy Bureau of Labor Statistics), and information on goods and services subject to the Kentucky general sales tax from http://www.lrc.ky.gov/kar/TITLE103.HTM and discussion with Department of Revenue personnel.

Of course, the tax burden increases for households of any income as the base is expanded. As the concern here is more related to the distribution of taxes, it is important to keep in mind that if tax revenue is to be kept neutral, for example, a broader base will allow lower rates. Then focusing on the distributional implications we might compare relative burdens across the income categories for the current code and the two alternatives. Under the current code, the tax burden as a share of income, for the household of average income is 1.33% while it is 1.24% for households with incomes in between $120,000 and $149,999. The ratio 1.33/1.24 is equal to 1.07, the tax burden, as a share of income, for the average household is seven percent more. For households with incomes between $20,000 and $29,999, their tax burden is estimated at 2.02% of income. This, then, is 62% more as a share of income (2.02/1.24=1.62) than the second highest bracket pays as a share of income.

A similar excise can be performed for the alternative tax bases. Adding consumer services and utilities makes the tax burden as share of income for the household of average income equal to 1.64% and for households with incomes between $120,000 and $149,999 equal to 1.49%. Then the average household is actually paying 10% more in the general sales tax as a share of income (1.64/1.49=1.10). For households with incomes between $20,000 and $29,999 the tax burden adding consumer services is 2.48% of income. This, then, is 62% more as a share of income (2.02/1.24=1.62) than the second highest bracket pays as a share of income. While this is only a comparison among a few of the income classes, it suggests that the addition of consumer services and utilities might slightly increase regressivity though the effect seems small.

Figure 4.2A: Estimated Direct Annual Sales Tax Burden by Income, Current Code & Alternative Proposals

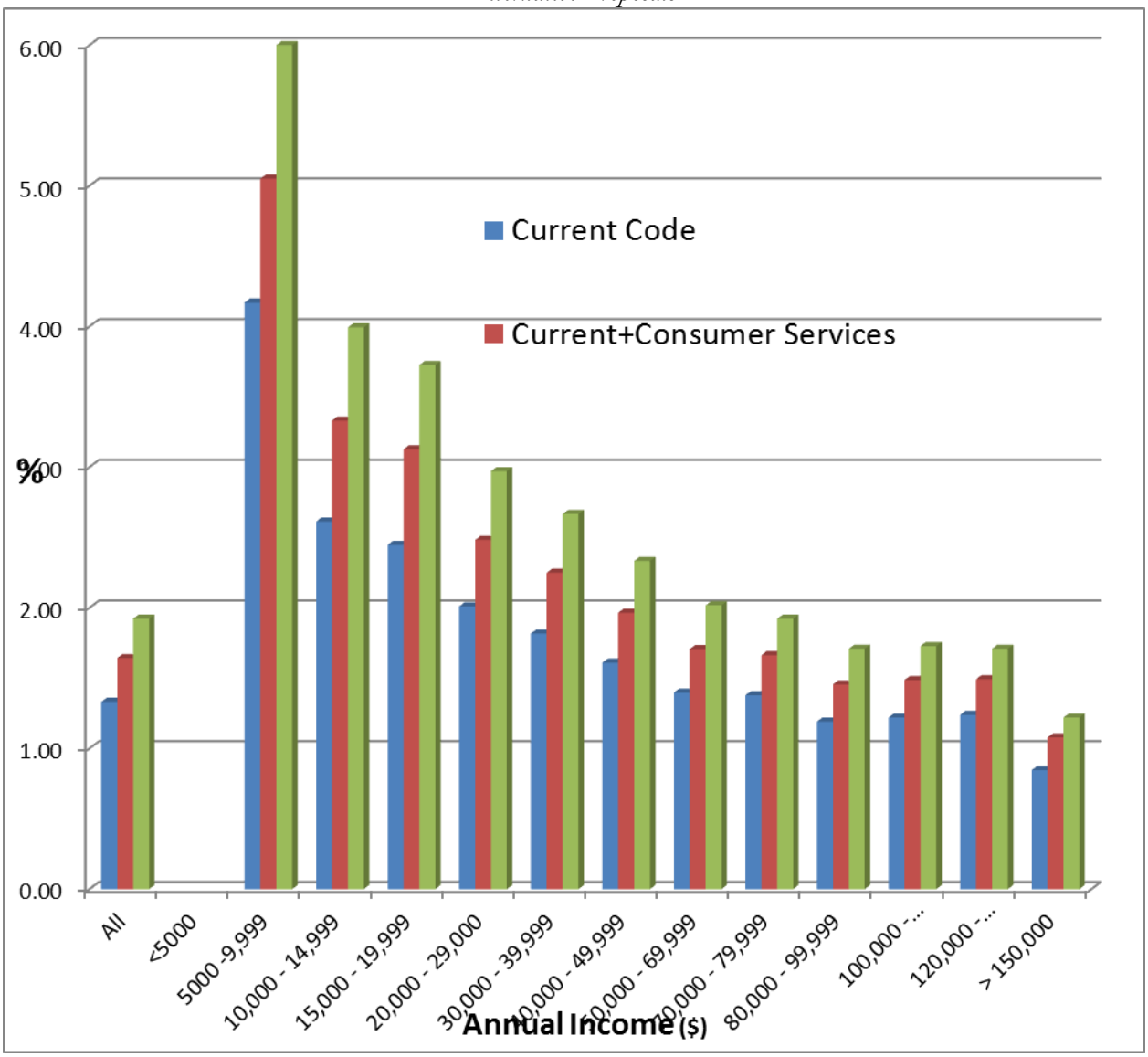


Source: Authors' calculations using the Consumer Expenditure Survey prepublication tables (courtesy Bureau of Labor Statistics), and information on goods and services subject to the Kentucky general sales tax from http://www.lrc.ky.gov/kar/TITLE103.HTM and discussion with Department of Revenue personnel.

Finally, not surprisingly, adding at home food expenditures makes the general sales tax more regressive. The tax burden as share of income for the household of average income equal to 1.92% and for households with incomes between $120,000 and $149,999 equals 1.71%. Then the average household is actually paying 12% more in the general sales tax as a share of income. For households with incomes between $20,000 and $29,999 the tax burden adding consumer services is 2.97% of income. This, then, is 74% more as a share of income than the second highest bracket pays as a share of income.

More detail on these comparisons and calculations on the tax base as a share of expenditures can be found in *Table A.4.1* in the *Appendix*.

Figure 4.2B: Estimated Direct Annual Sales Tax Burden as a Percentage of Income by Income, Current Code & Alternative Proposals



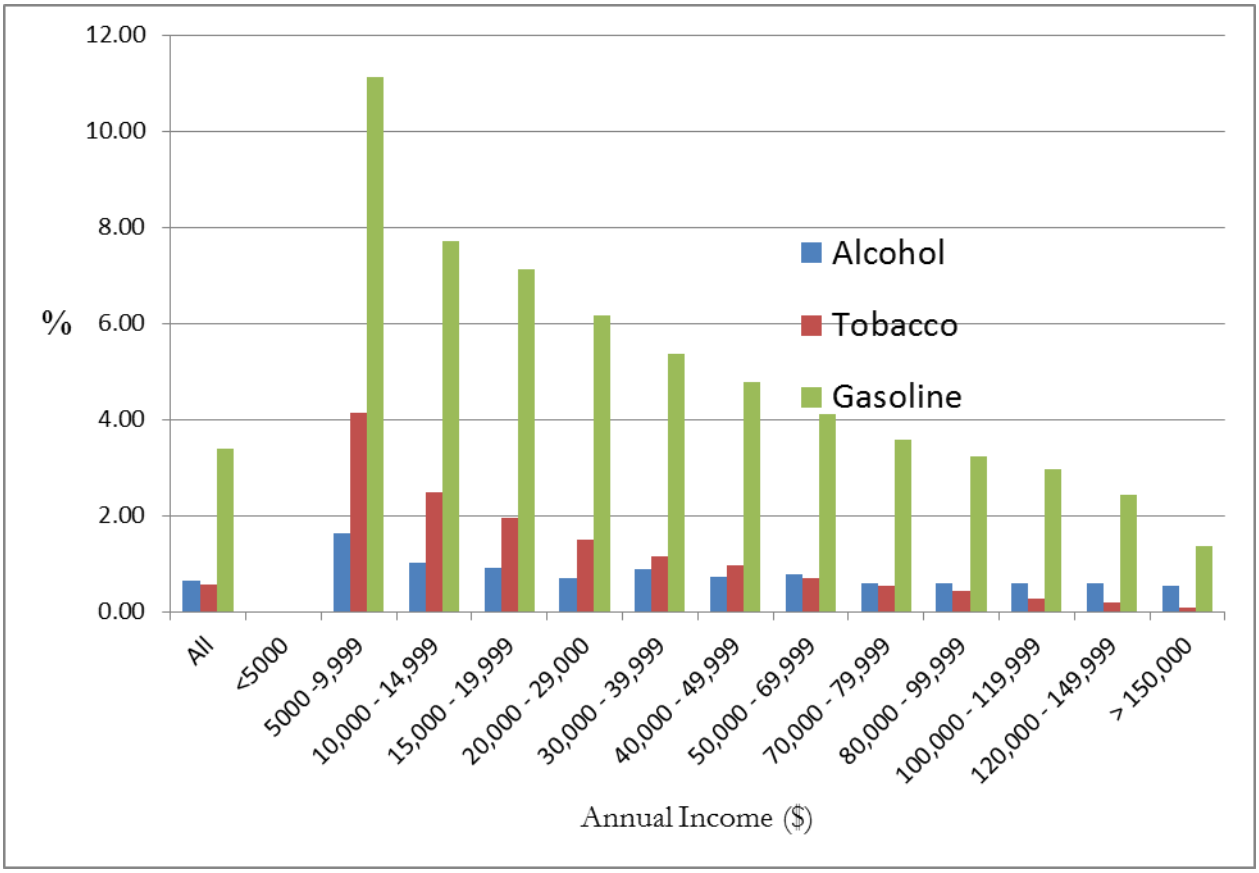
Source: Authors' calculations using the Consumer Expenditure Survey prepublication tables (courtesy Bureau of Labor Statistics), and information on goods and services subject to the Kentucky general sales tax from http://www.lrc.ky.gov/kar/TITLE103.HTM and discussion with Department of Revenue personnel.

4.3.1 Distributional Impact of Excise Taxes

A similar exercise can be performed for excise taxes. However, as can be seen from the earlier analysis on the general sales tax given the assumption the tax is fully borne by the consumer, the relative tax burdens, as a share of income, across the income distribution depend entirely on how much is spent on the tax goods as a share of income. Then, for the excise taxes on gasoline, tobacco, and alcohol, we do not report on tax burden as share of income but on household spending on these goods as a share of income. This, using the same sample from the Consumer Expenditure Survey for 2010, is summarized in *Figure 4.3*.

Given the declining share of income spent on tobacco and gasoline, taxes on these goods are likely to be regressive. For alcohol, it is less clear, as very low income households spend a higher share of income on it than higher income households, but there is not a great deal of difference between households in the middle and higher income brackets.

Figure 4.3: Expenditures on Alcohol, Tobacco, and Gasoline as Share of Income, by Level of Income



Source: Authors' calculations using the Consumer Expenditure Survey prepublication tables (courtesy Bureau of Labor Statistics).

4.4 Distributional Impact of Income Tax

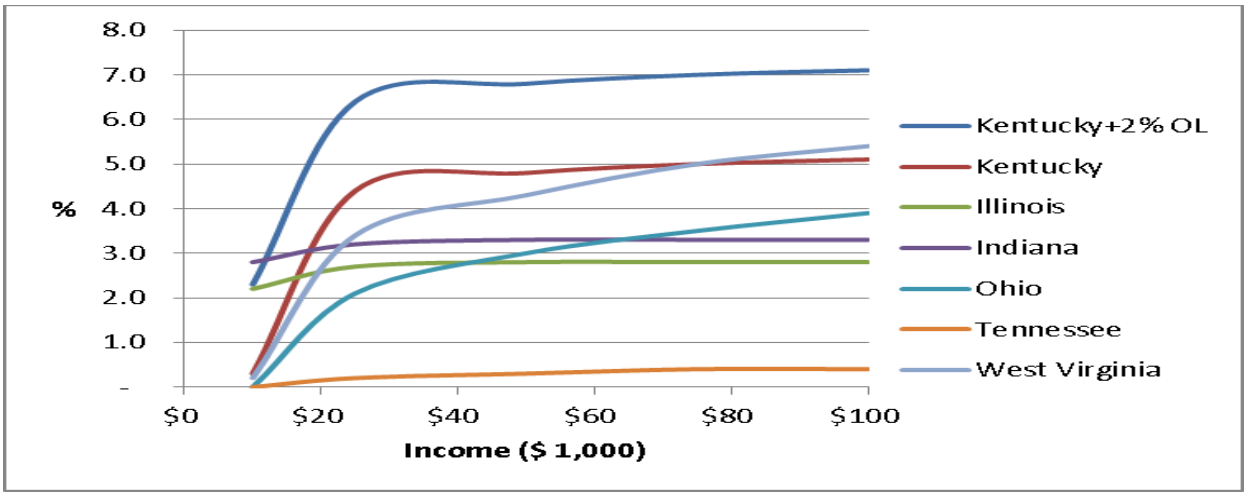
The complicated nature of the income tax can mean that tax burdens can vary substantially among households even with similar income, depending on the type of household, the source of earnings,

and consumption decisions such as owning versus renting a home. To get an indication of the how income tax burdens vary with income and household composition we report the state income taxes for Kentucky and its competitor states for four representative households for five different levels of income.

Figures 4.4A – 4.4D reports the percentage of income (average tax rate) for four different households in Kentucky and its contiguous neighbors excluding Missouri and Virginia because of their limited borders with Kentucky. Also included is the Kentucky average tax rate plus a 2% Occupational License tax as is found, for example, in Louisville and Lexington. In *Figure 4.4A* we show the average tax rate for a single filer, in *Figure 4.4B* rates are presented for joint filers with no dependents , *Figure 4.4C* reports rates for joint files with two dependents , and rates for a single taxpayer over 65 years of age are found in *Figure 4.4D*. In each table, the average tax rate is reported for households with incomes of $10,000, $25,000, $50,000, $75,000, and $100,000. These calculations were done by the National Bureau of Economic Research (NBER) and were done by the NBER program TaxSim for 2010.[32]

Compared to its competitor states, Kentucky has higher average income tax rates between $25,000 and $100,000 with rates ranging from 1% to 2% higher. For households with $10,000 or less its rates are generally equal to or less than in competitor states. As can be seen in the figures Kentucky tax rates increase dramatically between $10,000 and $25,000 for single filers and joint filers with no dependents. For joint filers with dependents and single filers over 65 years of age, taxes are progressive through $50,000. Note that in *Figure 2C* the average income tax rate in Kentucky's competitor states is actually negative for an income of $10,000. This is because several competitor states have a state Earned Income Tax Credit (EITC) program for which employed, low income households are eligible[33]. *Tables A.4.2A – A.4.2D* in the Kentucky provide more detailed information on state income tax payments, payments as a percent of income, and payments in other states relative to Kentucky.

Figure 4.4A: State Personal Income Taxes for Single Filers as a Percentage of Income (2010)



[32]Information on the calculation can be found at http://users.nber.org/~taxsim/state-tax-tables/ . The NBER has income as 91% wages, 6% dividends, and 3% from taxable interests. Deductions are $100 + 2% of income for real estate taxes, $100 + 2% of income for charitable giving, and $100 + 6% for mortgage interest.
[33]Competitor states that have state *EITC* programs include Illinois, Indiana, and Virginia.

Figure 4.4B: State Personal Income Taxes for Joint Filers with No Dependents as a Percentage of Income (2010)

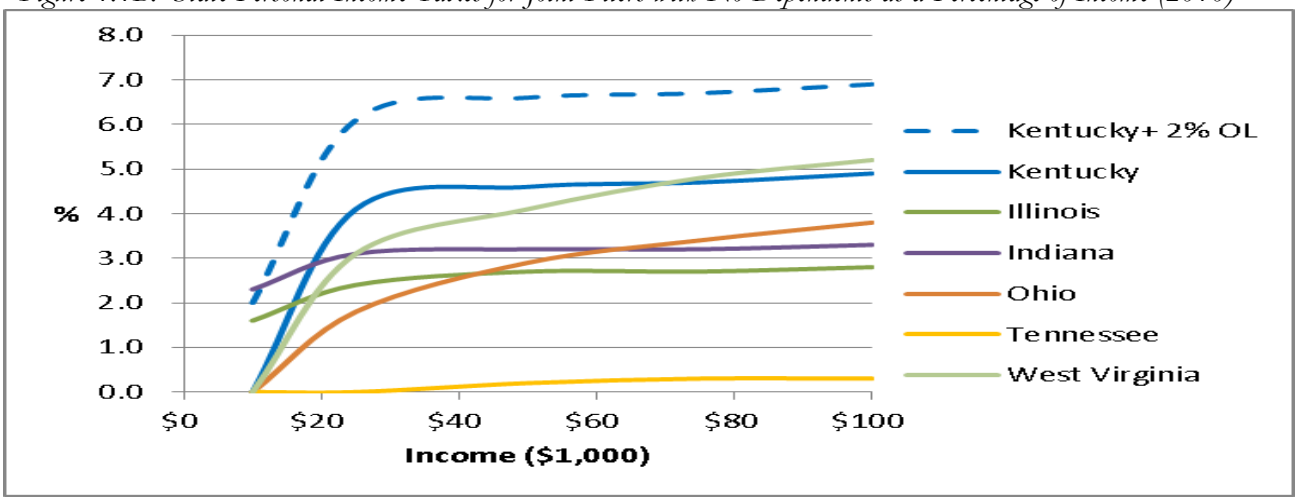


Figure 4.4C: State Personal Income Taxes for Joint Filers with 2 Dependents as a Percentage of Income (2010)

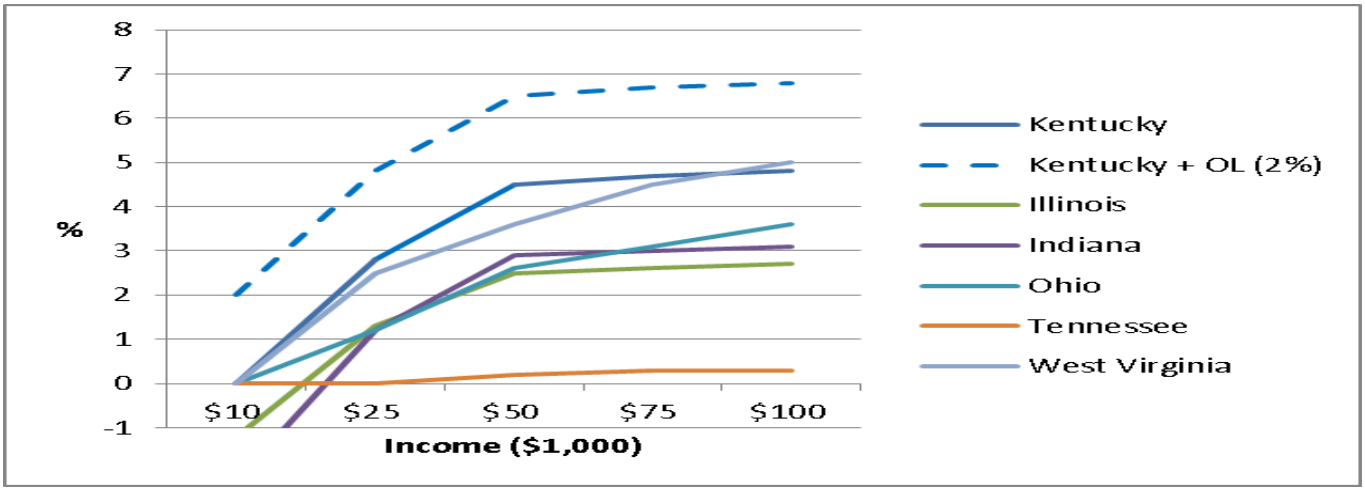
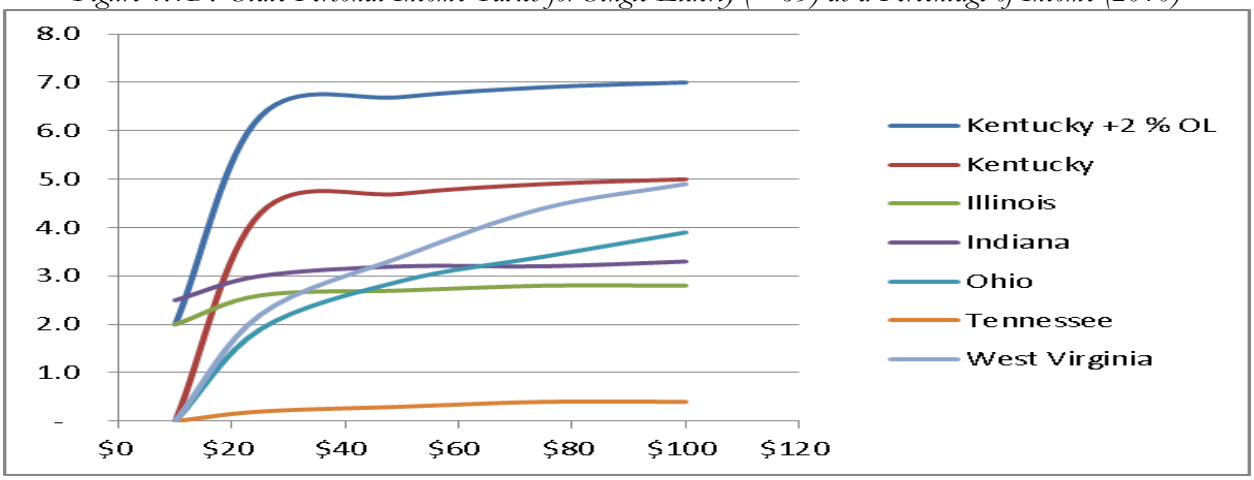


Figure 4.4D: State Personal Income Taxes for Single Elderly (> 65) as a Percentage of Income (2010)



Source: Authors' calculations using simulated taxes from National Bureau of Economic Research (NBER) TaxSim website http://users.nber.org/~taxsim/state-tax-tables/ .

4.5 Distributional Impact of Business Taxes

People pay taxes, not businesses is a basic tenant of economics. Taxes that are initially imposed on business, and the corporate income tax in particular, could be paid by the purchasers of goods and services, suppliers of inputs such as labor or land, or owners of businesses. Disentangling who actually pays the tax is very difficult both conceptually and practically and must be based on careful economic analysis. A number of economists have examined who pays state and local taxes on capital and concluded that a complicated national average is paid by the owners of capital.[34] But, since investments in Kentucky can move to avoid the tax, increases or decreases in Kentucky's corporate tax are likely to be borne by immobile factors in the state. Thus, a corporate tax increase (decrease) will result in lower (higher) wages or lower (higher) land prices. Empirical research in a recent paper from the Federal Reserve Bank of Kansas City concluded that higher corporate income taxes result in lower wages in the state.[35] Higher corporate taxes are found to have an increasingly negative effect on wages and the impacts are greatest on the best educated workers.

Policy makers should not be surprised that higher taxes on business reduce returns to less mobile factors in the state, and particularly workers. Businesses can respond to high tax rates by shifting some investment and production out of the state. Workers are less productive when they have less capital to work with so their wages go down as a result. Workers could choose to move to another state where earnings are higher, but households are much less inclined to move because of linkages to their homes and communities. A clear outcome of these results is that states can only expect to "export" taxes to other states in rare exceptions, such as when the tax is levied on a very specialized product in which the state has considerable power in the national or international pricing of the good. Otherwise, taxes imposed on business in Kentucky are likely to be borne in lower earnings from Kentucky residents rather than by people from outside the state.

[34] See Mieszkowski and Zodrow (1999) for example.

[35] Felix, Alison. 2009. "Do State Corporate Income Taxes Reduce Wages?" Kansas City Federal Reserve Bank Review, Second Quarter, pp. 77-102.

5. *The Competiveness of the Kentucky Tax System*

In this section we have several objectives. We first compare Kentucky to its competitor states in a number of measures of economic growth. Still focusing on comparisons of economics growth, we next provide some comparisons along Kentucky borders as these are areas which, in terms of state policies, are probably the most competitive. Next we review and assess studies examining the relative burden of taxes on Kentucky and competitor states. Finally, we provide a review and discuss the implications of the extensive literature in economics of the impacts of state taxation on employment and firm location.

5.1 Economic Growth in Kentucky and its Competitor States

There are many reasons why some regions may have less economic success or grow more slowly than neighboring regions. Certainly, economic evidence suggests that government policies, including taxes, might be one reason but certainly not the only reason. Here, we offer some comparisons between Kentucky and its competitor states in employment, population, earnings, and income. Certainly some of these differences might be attributable to differences in tax policies, but it is unlikely that tax policies alone explain much of the differences among these states. We begin with comparisons of per capita income.

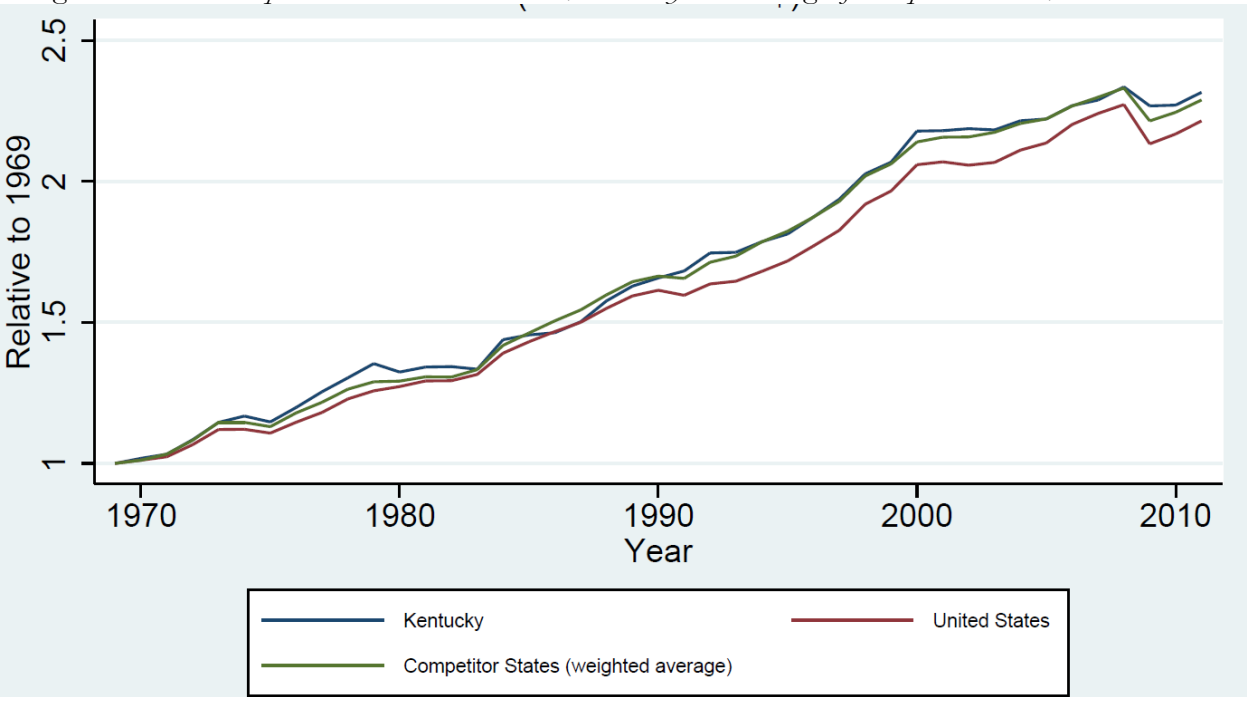
5.1.1 Income Growth and Level

Figure 5.1A illustrates the trend for real income per capita for Kentucky, a weighted-average of its competitor states, and the U.S. average from 1969 – 2011 where income is measured relative to 1969. As the figure shows, the growth pattern for Kentucky and its competitor states have been virtually the same and very similar to the United States average prior to 1990. After 1990 growth rates for the U.S. slowed but continue strong for Kentucky and its competitor states. The decrease in per capita income in 2008 was relatively mild for Kentucky compared to its competitors and particularly compared to the United States average. By 2011 Kentucky per capita income returned to its 2008 peak while it still lags for the U.S. as a whole and Kentucky's competitor states. More detail on Kentucky and its competitor states can be found in *Table 5.1* in the *Appendix*.

Figure 5.1B compares the per capita income for Kentucky and its competitor states relative to the U.S. average for 2010. Kentucky's per capita income is eighty percent of the U.S. average making it the third lowest among the states, virtually the same as West Virginia's and only slightly above Mississippi. The only states above the U.S. average are Illinois and Virginia.[36]

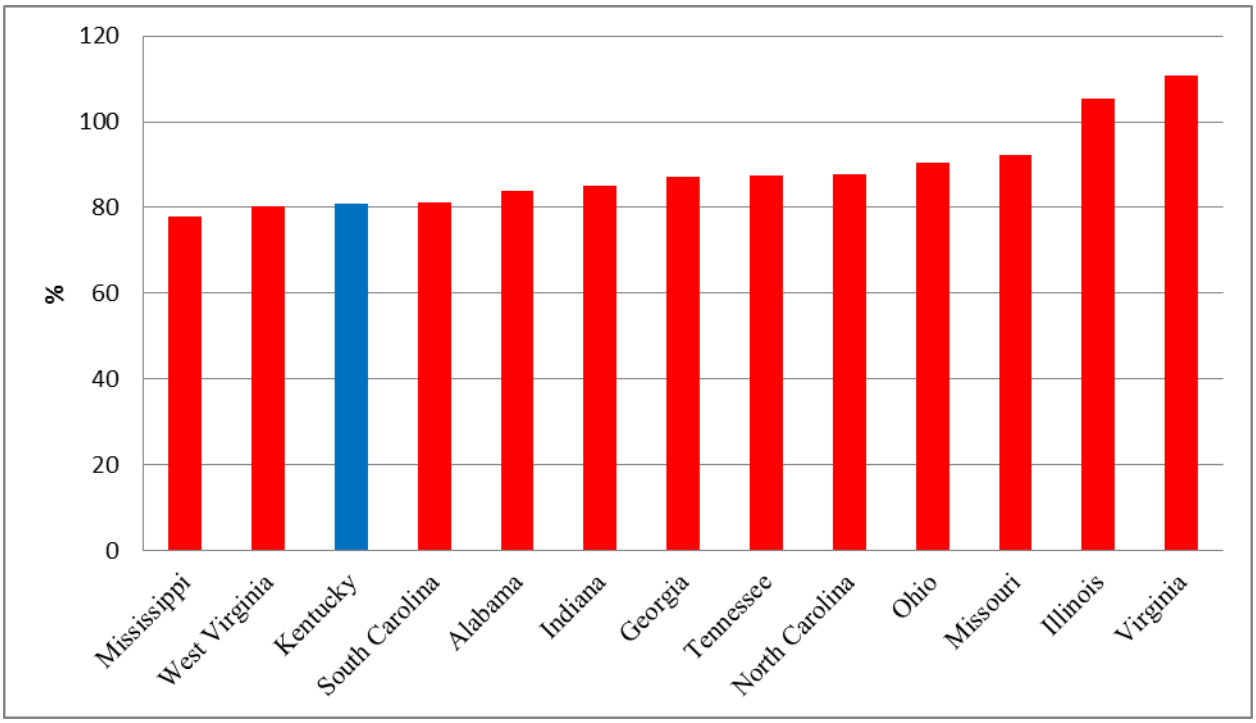
[36]It is important to note these are nominal dollars and not adjusted in cost of living differences among states.

Figure 5.1A: Per Capita Income relative to 1969, Kentucky and Average of Competitor States, 1969 – 2011



Note: All series are normalized to one in 1969.
Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Figure 5.1B: Income per Capita as Percentage of U.S. Average, Kentucky and Competitor States (2010)



Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

5.1.2 Population Growth

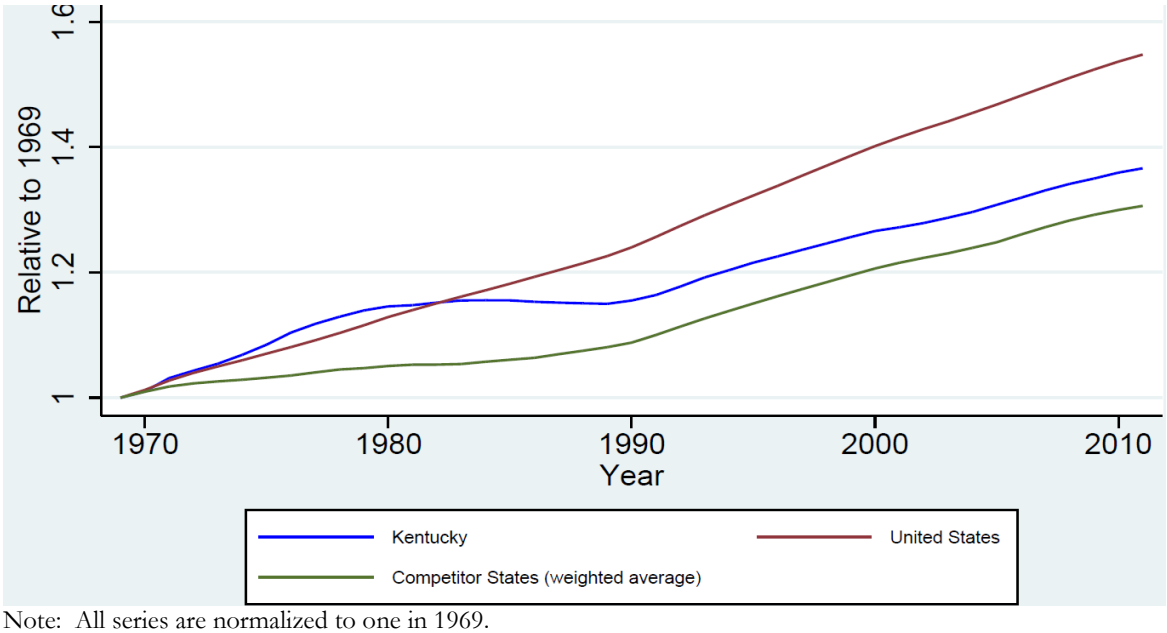
Figure 5.2 shows trends in population for Kentucky, its competitor states, and the U.S. average. For each population, relative to 1969 is plotted. Kentucky's population has grown by approximately thirty percent in this period, slightly above the average of its competitor states but below the U.S. average. Kentucky's population saw rapid growth in the 1970's and was flat (0.07%) in the 1980's, rebounding in the 1990's. In the *Appendix, Table A.5. 2* provides detailed information about the annual population growth rate by decade from 1969 to 2011 for Kentucky and its competitor states as well as total growth from 1969 to 2011 and 2001 to 2011.

5.1.3 Earnings

Figure 5.3A illustrates the growth in real private earnings per employee, for Kentucky and its competitor states, from 1969-2010. The states form 5 distinct groups, with Virginia demonstrating the highest growth at nearly 80% over this time period. Kentucky's growth, at nearly 35%, occupies a category with Missouri and Illinois that is ahead of the lowest group (i.e., Ohio, Indiana, and West Virginia), but still trailing 9 of the 12 competitor states. *Table A.5.3* provides the annual growth rate in private earnings per employee for the U.S., competitor states in aggregate, Kentucky and each of the states, for various time periods, including 1969 to 2010.

Figure 5.3B shows the growth in real private earnings per employee, for Kentucky and its competitor states, from 2001-2010. The economic downturn that began toward the end of 2007 has taken its toll on private earnings. Seven of the states, including Kentucky, experienced a real decline in private earnings per employee from 2001 to 2010. Ohio suffered the largest decline of 8% while Virginia's experienced an increase of slightly more than 4%. Kentucky's decline in real private earnings from 2001-2010 was nearly 2%.

Figure 5.2: Population Relative to 1969, Kentucky and Average of Competitor States, 1969 – 2010



Note: All series are normalized to one in 1969.
Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

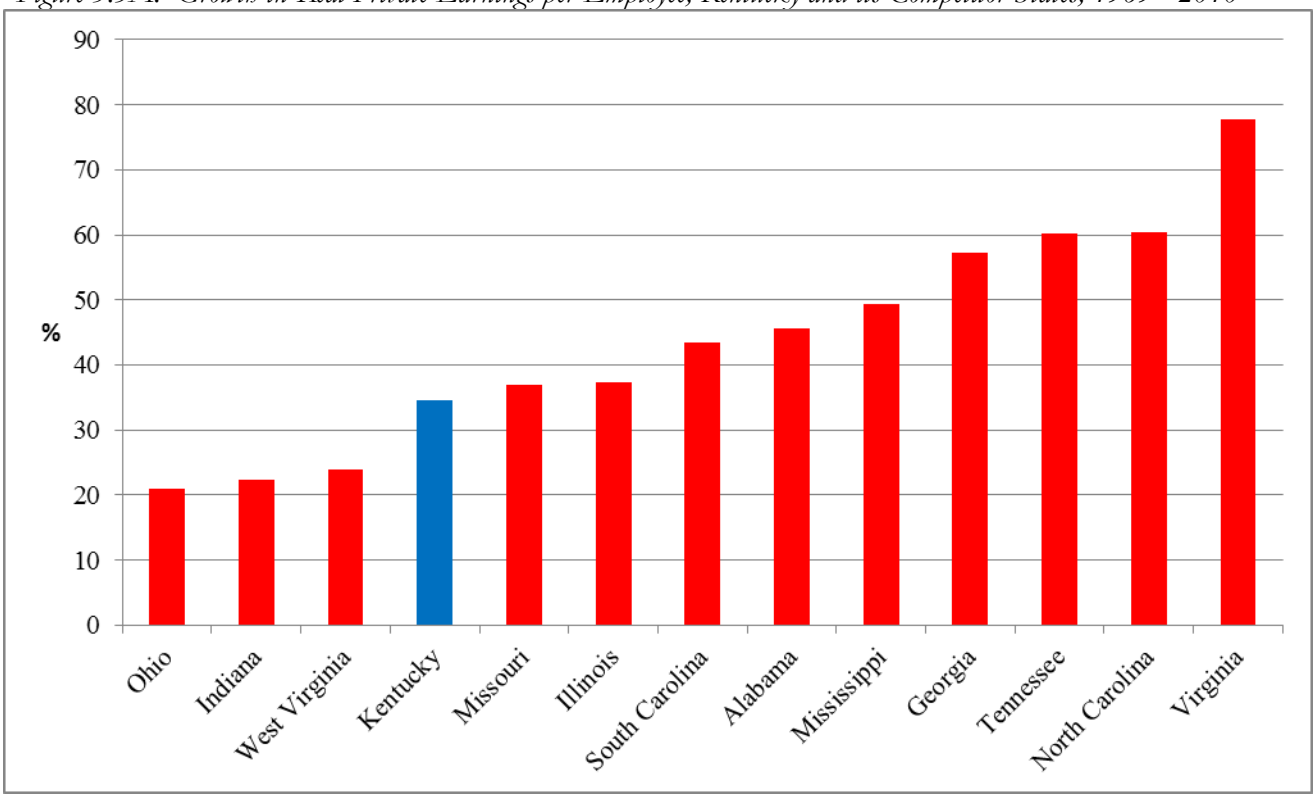
Figure 5.3C shows the private earnings per employee relative to the U.S. average, Kentucky and its competitor states ($2010). Unsurprisingly, these data are similar to those presented in *Figure 5.1B*, which show Kentucky at about 80% of the U.S. average for both per capita income and private earnings per employee.

5.1.4 Employment

Figure 5.4A presents the growth in total employment, for Kentucky and its competitor states, from 1969-2010. At over 140%, Georgia experienced the largest increase in total employment during this period—driven by the meteoric growth of Atlanta. Kentucky, with a growth of nearly 80%, is firmly in the middle of the pack of competitor states. Ohio experienced the lowest growth—about 40%.

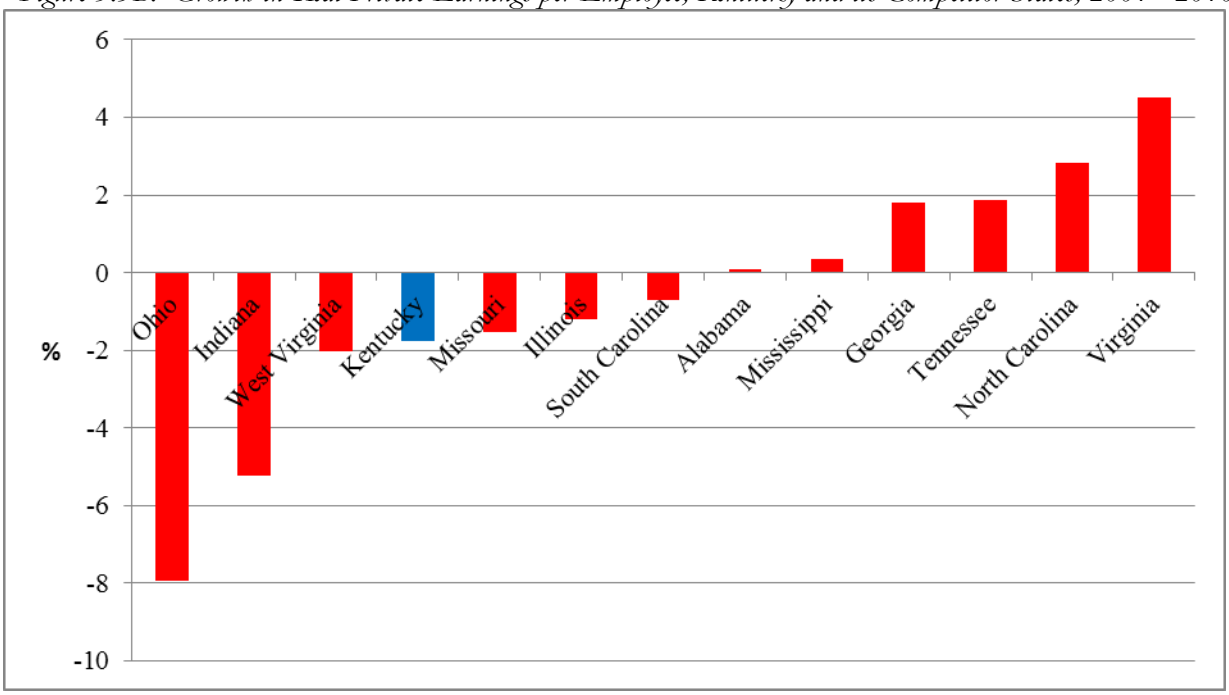
Figure 5.4B shows the growth in total employment, for Kentucky and its competitor states, from 2001-2010. In the more recent period of 2001 to 2010, Kentucky's total employment grew about 3%, which lagged Georgia (about 9%), the leading state, but was higher than six other states—three of which experienced declines in total employment (i.e., Ohio, West Virginia, and Illinois).

Figure 5.3A: Growth in Real Private Earnings per Employee, Kentucky and its Competitor States, 1969 - 2010



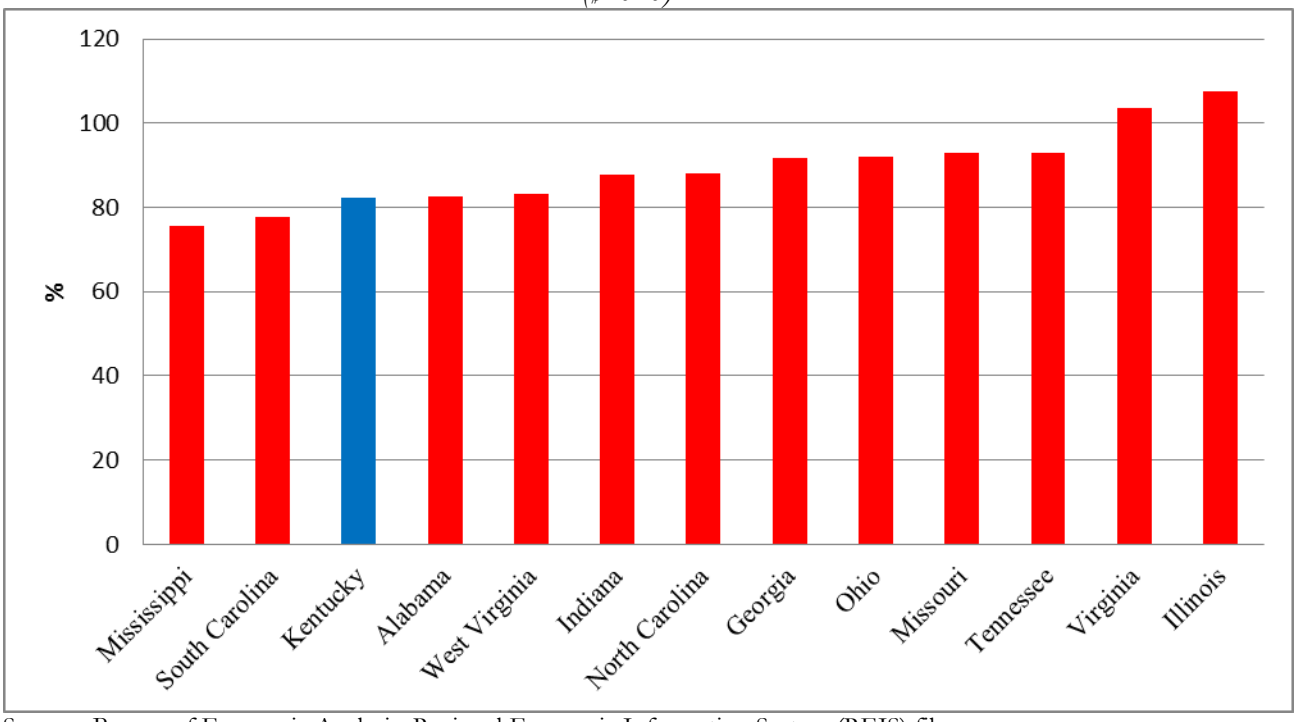
Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Figure 5.3B: Growth in Real Private Earnings per Employee, Kentucky and its Competitor States, 2001 - 2010



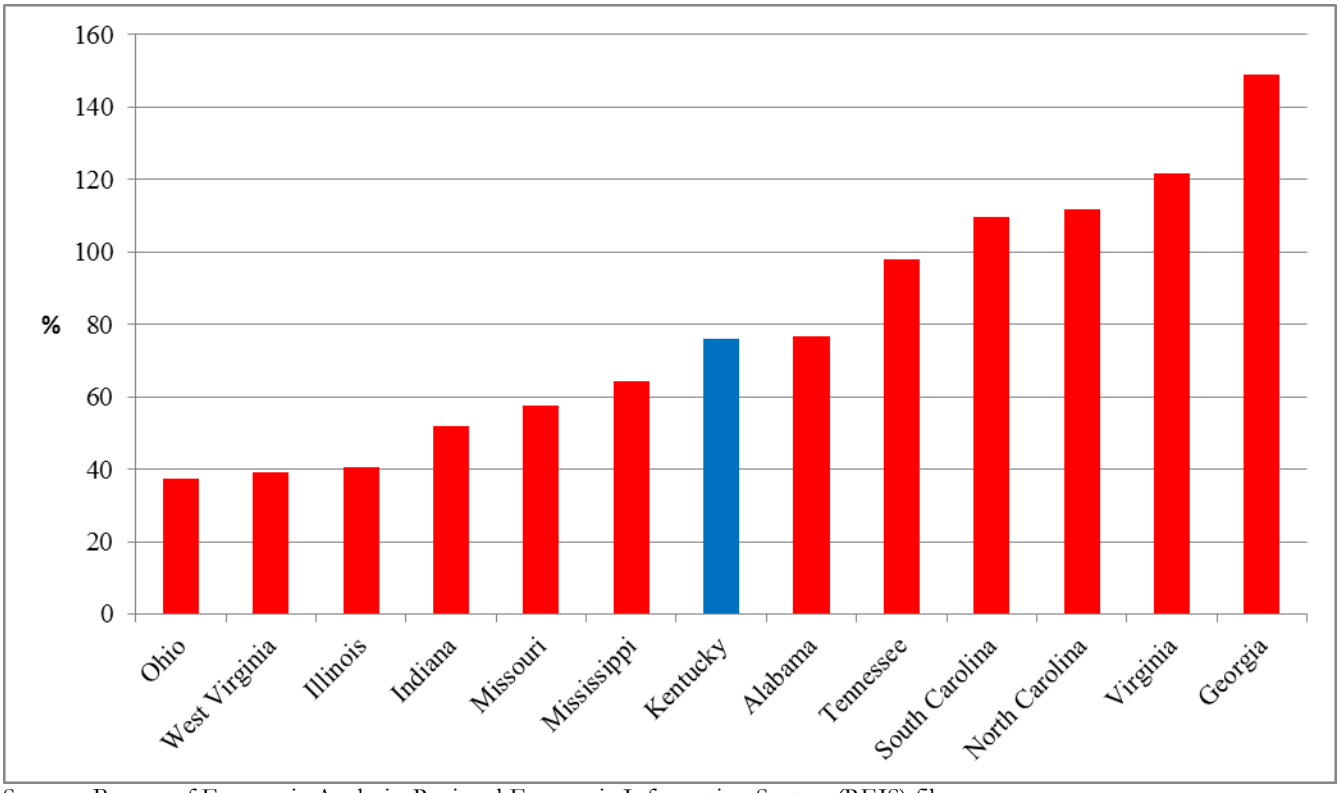
Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Figure 5.3C: Private Earnings per Employee relative to the U.S. Average, Kentucky and its Competitor States ($2010)



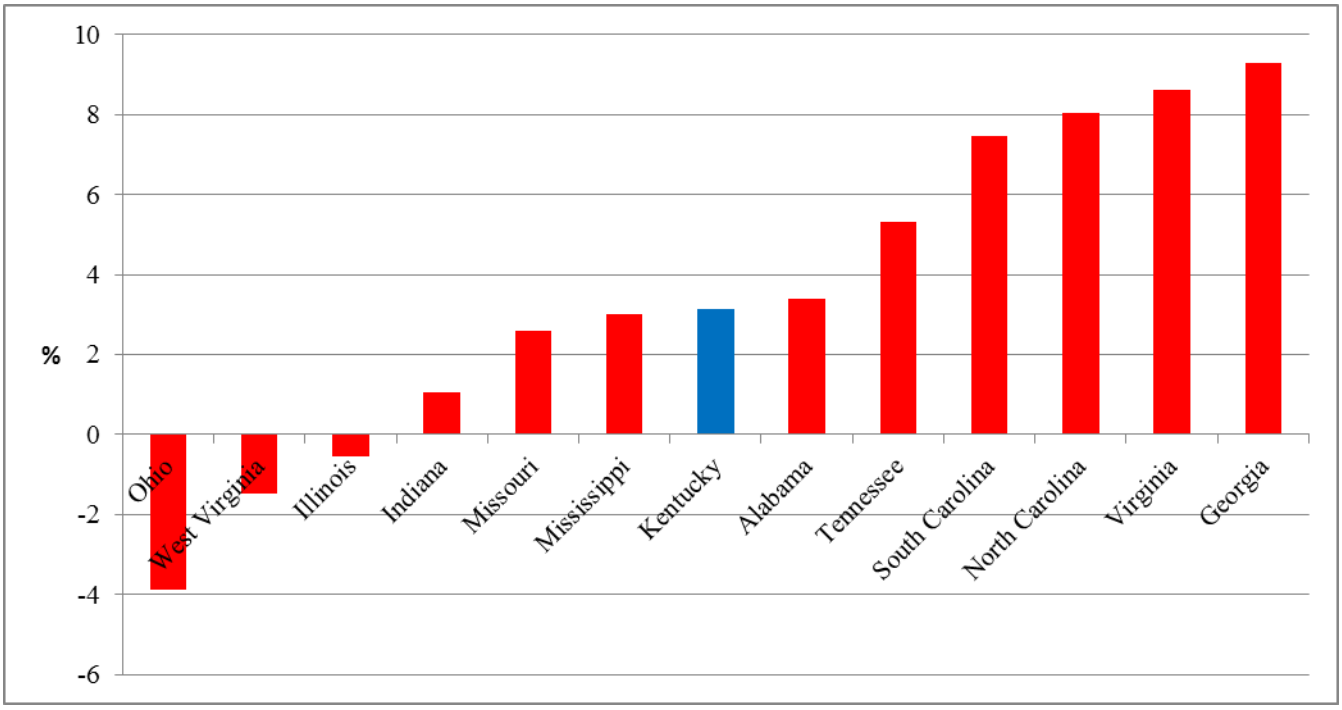
Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Figure 5.4A: Growth in Total Employment, Kentucky and Competitor States, 1969 – 2010



Source: Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Figure 5.4B: Growth in Total Employment, Kentucky and Competitor States, 2001 – 2010



Source: Authors' calculations and Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

5.2 Comparisons of Economic Growth on Kentucky Borders

Now, rather than comparing economic growth based on entire states, we consider growth along Kentucky's borders. We do this primarily for two reasons: first, given Kentucky's shape and distribution of population, economic activity on its borders is large and therefore Kentucky is more prone to competitive pressures from other states than most other states. Second, borders are a unique opportunity to consider the differences state policies might cause in economic conditions because of the similarity of other economic considerations at borders. Thus, for example, Albany, IN and Jefferson County are in the same metropolitan area with both areas reasonable commutes for households and both areas have access to the greater Louisville market. One of the primary differences between the two areas is that one is Kentucky and one is in Indiana, each subject to the state policies, including but not exclusively tax policy, in their respective states.

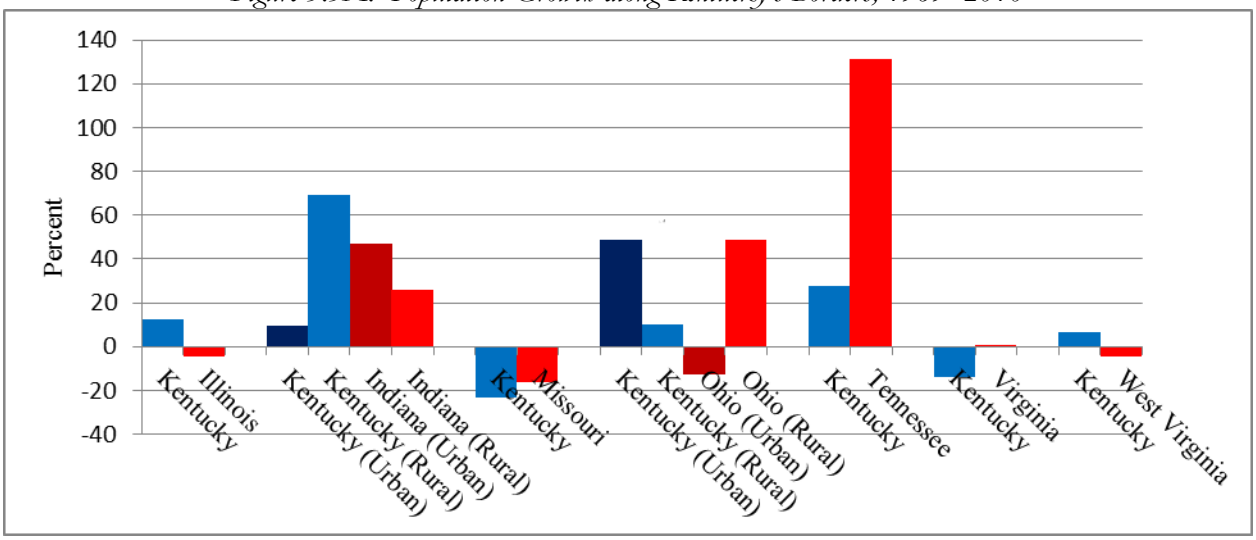
We make comparisons on economic growth on Kentucky's borders by matching Kentucky counties along the border with counties in the bordering state. Comparisons are made state by state (Kentucky/Illinois; Kentucky/Tennessee, etc.) and distinguishing rural and metropolitan areas (Louisville MSA and Cincinnati MSA) as well. Data on the measures of growth come from the Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

For these state borders we compare growth for five measures: population (*Figure 5.5A)*, employment *(Figure 5.5B)* real personal income per capita *(Figure 5.5C),* real earnings *(Figure 5.5D),* and real earnings per employee *(Figure 5.5E).*

In *Figure 5.5A*, we can see that population in Kentucky counties along the Illinois grew between 1969 and 2010 while it actually declined in the Illinois counties. Along the Indiana border Kentucky population grew much faster than in Indiana but slower in the urban areas (Louisville). Given that in the Louisville area Kentucky would have been much more developed in 1969 than the Indiana side this is probably not surprising. Population in both Missouri and Kentucky border counties declined with little change in Kentucky's borders with West Virginia and Virginia. In the urban Kentucky-Ohio border (Cincinnati) population actually decreased in Ohio but increase by about fifty percent in Kentucky. Most noticeable are the dramatic differences in population growth along the Kentucky-Tennessee border during this period.

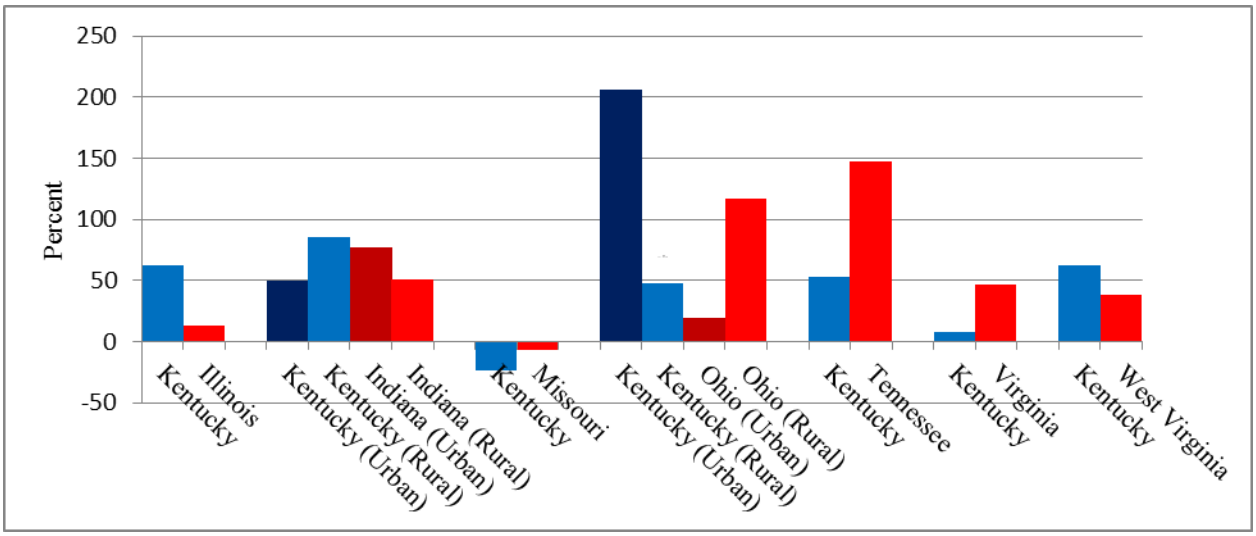
Not surprisingly, the figure for employment growth *(Figure 5.5B)* mostly mirrors that for population growth with a few differences worth noting. First, the large increase in employment in the Kentucky border counties in the urban Kentucky-Ohio border. Note also that employment in the Kentucky counties along the Kentucky-Tennessee border increased much more than the population did, probably explained by higher labor force participation.

Figure 5.5A: Population Growth along Kentucky's Borders, 1969- 2010



Source: Authors' calculations and Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Figure 5.5B: Employment Growth along Kentucky's Borders, 1969- 2010



Source: Authors' calculations and Bureau of Economic Analysis, Regional Economic Information System (REIS) files.

Unlike some of the pronounced differences in population and employment growth along Kentucky's borders, as can be seen in *Figure 5.5C* growth in real personal income per capita is quite similar along all of Kentucky's borders. Growth in earnings per employee *(Figure 5.5D)* shows some differences. Most noticeably earnings per employee had appreciably greater growth in Kentucky than Tennessee. Earnings per employee in Kentucky border counties grew at a faster rate than those in their Illinois and rural Indiana neighboring counties. In contrast, there was significantly greater growth in earnings per employee in West Virginia than Kentucky.

Figure 5.5C: Real Personal Income per capita Growth along Kentucky's Borders, 1969- 2010

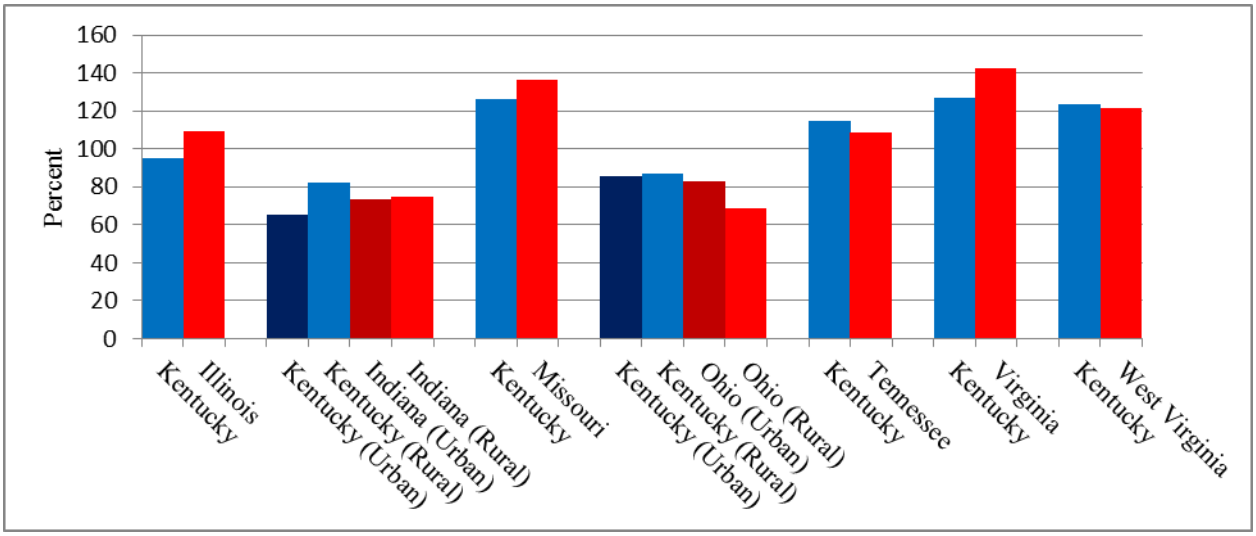
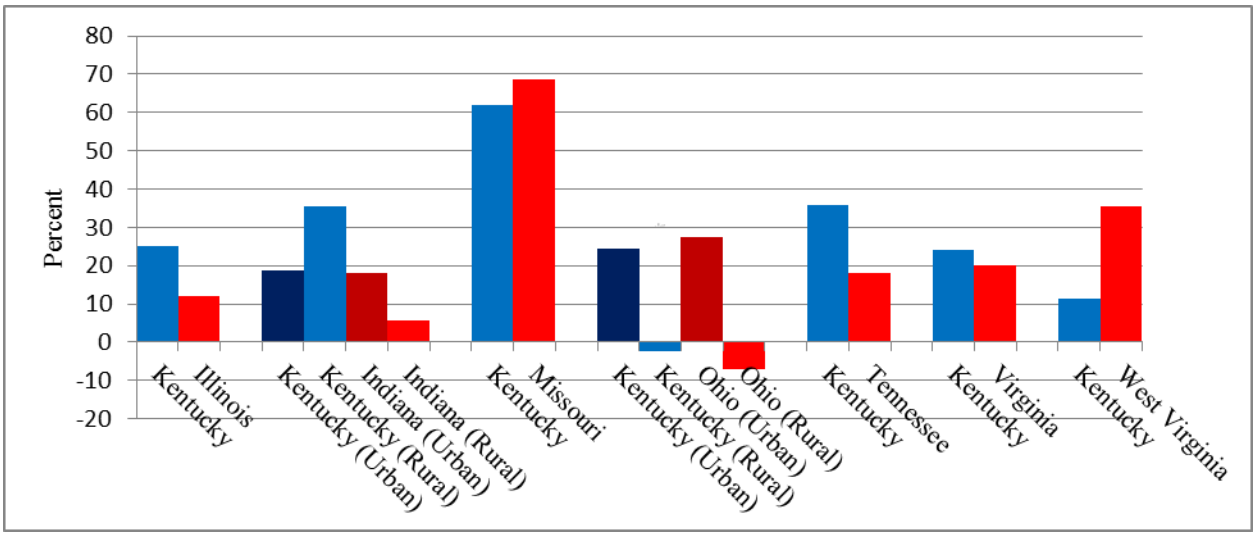


Figure 5.5D: Real Earnings per Employee per capita Growth along Kentucky's Borders, 1969- 2010



5.3 The Burden of Taxes on Businesses in Kentucky and its Competitor States

In Section 2, we provided an overview of Kentucky's tax structure and offered some comparisons with its competitor states. To better understand Kentucky's competitive position a closer examination of its business tax structure is warranted. Then relying on several recent studies of business taxation, we offer a summary of Kentucky's business tax structure and how it compares to its competitors.

What constitutes a tax on business? We follow the approach adopted in a number of studies done by the Council on State Taxation (COST). The list of business taxes as well as total 2011 tax collections for state and local for governments for the United State and Kentucky are found in *Table 5.1*.

Table 5.1: State and Local Business Taxes 2011, United States Total and Kentucky

	United States Total		Kentucky	
Business Tax	$Billion	%Total	$Billion	%Total
Property Tax on Business Property	244.9	38.0%	2	29.0%
General Sales Tax on Business Inputs	129.7	20.1%	1.3	18.8%
Corporate Income Tax	46.3	7.2%	0.6	8.7%
Unemployment Insurance	41.2	6.4%	0.5	7.2%
Business and Corporate License	37.3	5.8%	0.7	10.1%
Individual Income Tax on Business Income	36.3	5.6%	0.5	7.2%
Excise Taxes	35	5.4%	1.3	18.8%
Public Utility Taxes	28.8	4.5%		
Insurance Premium Taxes	17.2	2.7%		
Severance Taxes	14.8	2.3%		
Other Business Taxes	12.4	1.9%		
Total	$ 643.9		$ 6.9	

Source: Andrew Phillips, Robert Cline, and Hon Ming Quek, *Total State and Local Business Taxes: State-by-State Estimates for fiscal year 2011,* Ernst & Young/COST (July 2012).

Figure 5.6 shows the distribution of business tax collection from the major revenues sources for the state and local government in the United States and Kentucky. As the figure suggests, Kentucky sources of business taxes do not differ substantially from those of the United State average with the exception of the property tax and excise taxes. On average, 42 percent of business taxes for state and local governments in the United States is from the property tax while it is only 29 percent in Kentucky. In contrast, Kentucky state and local governments collect almost 10 percent of its business tax revenue from excise taxes while the U.S. average is slightly more than 5 percent.[37]

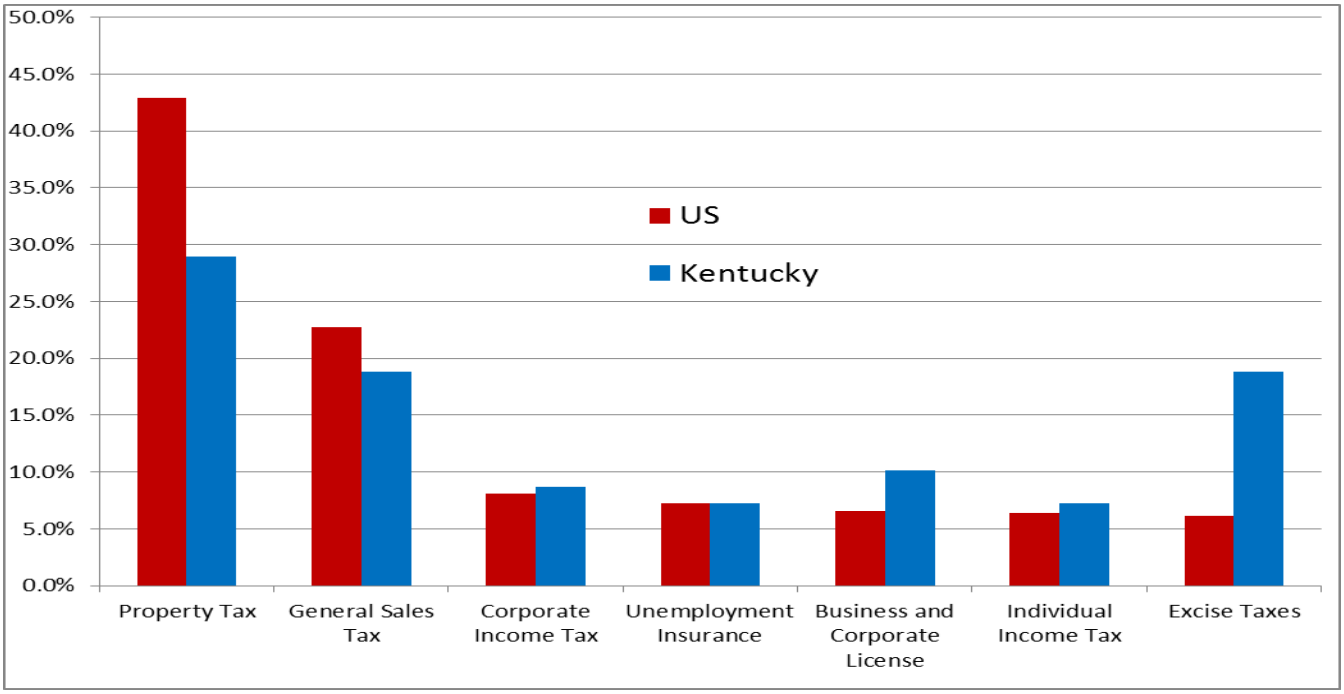
How does Kentucky compare to its competitors in the level of business taxation? *Figure 5.7* illustrates business taxation as a share of private sector gross state product (GSP) for fiscal year 2011. The average competitor states has business taxes equal to 4.2 percent of GSP; in Kentucky it was 5.5 percent in 2011, ranking third highest behind Mississippi and West Virginia.

An alternative ranking of state and local business taxation is offered in another study by Ernst and Young for the Council on State Taxation.[38] In this study they consider five representative facilities (Headquarters, Research and Development, Office and Call Center, Durable Manufacturing, and Non-Durable Manufacturing). Then based on information on the assets, liabilities, receipts, deductions, and net income of these facilities determine the impact state and local taxes have on the rate of return on the facility investment over a period of thirty years. Thus if state and local taxes reduce the rate of return from 15% to 13% this is an effect rate of 13.3% ((15-13)/15).

[37]The low use of the property tax on business property can be seen from the rankings of Louisville's property tax burden for commercial and industrial property as determined in "50-State Property Tax Comparison Study," (Minnesota Taxpayers Association and the Lincoln Institute (April 2011). For commercial property, Louisville ranked 31st – 33rd highest effective property tax rate of the 50 largest cities depending on the nature of the commercial property assessed. For industrial property it ranked between 45th and 47th.

[38]Robert Cline, Andrew Phillips, and Thomas Neubig, "Competitiveness of State and Local Business Taxes on New Investment: Ranking States by Tax Burden on New Investment," Ernest & Young and COST (April 2011).

Figure 5.6: Distribution of Business Taxation, United States Total and Kentucky, 2011



Source: Authors' calculations and Andrew Phillips, Robert Cline, and Hon Ming Quek, *Total State and Local Business Taxes: State-by-State Estimates for fiscal year 2011,* Ernst & Young/COST (July 2012).

Figure 5.8 reports effective tax rates on new investment for Kentucky and its competitor states. As the effective tax rate *(ETR)* for five different facilities had to be averaged a weight for the averaging had to be used. The *ETR* we report is based on a weighting by capital invested in the facility; alternatively jobs could be done. The order of the states in is relatively unchanged by the weighting so we restrict ourselves to presenting the findings based on the capital weighting.

In this measure of business taxation, Kentucky ranks 4th among the 13 states, a stark difference in its ranking based on business taxes as a percentage of gross state product. Only Ohio Illinois, and Virginia have lower effective tax rates. The effective tax rate is 6.5% for Kentucky compared to an average for its twelve competitors of 7.69%.

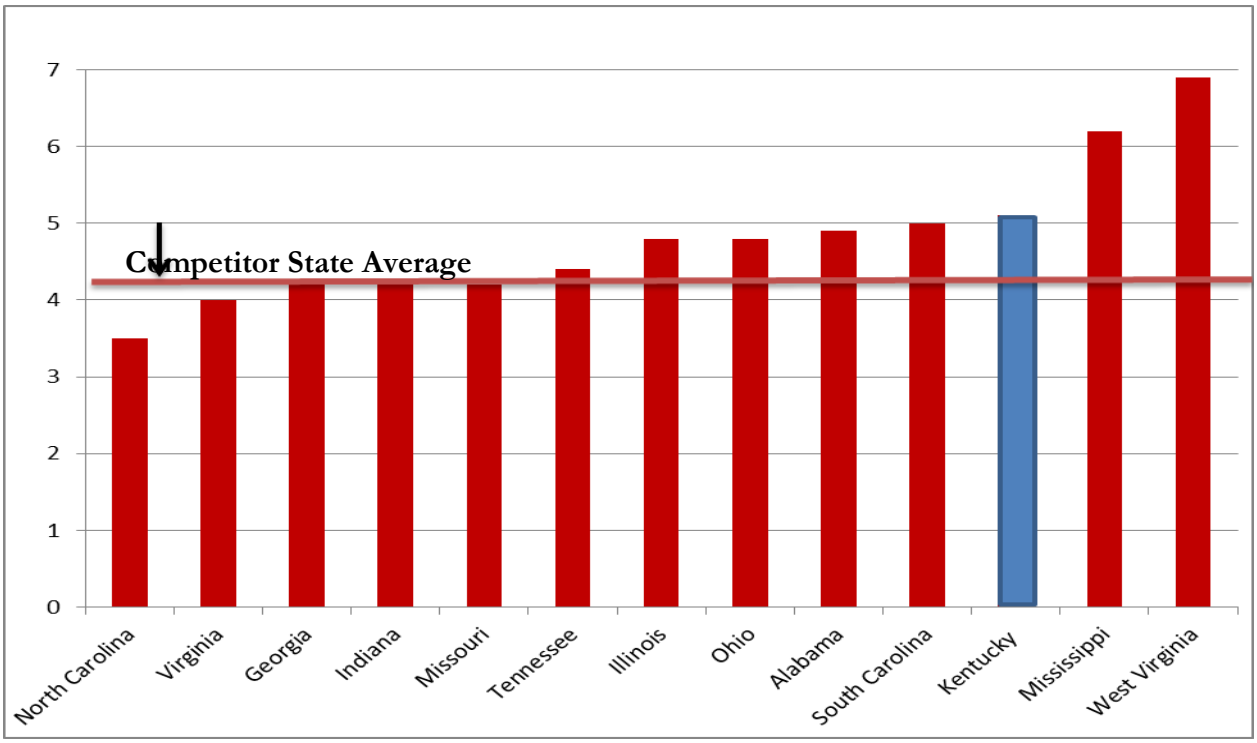
Thus while the ranking of Kentucky among its competitors based on business taxes as percentage of gross state product is high, perhaps concerns about its competitive position are somewhat alleviated based on the rankings based on the Ernest & Young/COST ranking of the effective tax rate on new investment. To the extent this ranking generalizes to a broader range of investment, it suggests that Kentucky might be fairly successful at targeting lower tax rates on more elastic business capital, specifically new investment.

A similar methodology was employed by a 2012 study by the Tax Foundation and KMPG to examine business tax burdens.[39] In addition to looking at the tax burden on new investment, the

[39]"Location Matters: A Comparative Analysis of State Tax Costs on Business," Tax Foundation and KMPG, Washington, DC 2012.

study looks at new firms, eligible for tax incentives, and as a mature firm not eligible for incentives. This distinguishes it from the COST study that does not incorporate incentives into their calculation. As with the COST study, the Tax Foundation/COST study considers alternative types of firms: corporate headquarters, R & D facilities, a retail state, call center, distribution center, and capital-intensive manufacturing. The results of the study are generally consistent with that of the COST study. Overall, Kentucky ranks 18th among all states and 5th among its competitor states for (low) tax burdens on mature firms. For new firms, Kentucky ranks 7th among all states and 3rd among competitor states.

Figure 5.7: Business Taxes as a Percentage of Private Sector Gross State Product FY2011



Source: Authors' calculations and Andrew Phillips, Robert Cline, and Hon Ming Quek, *Total State and Local Business Taxes: State-by-State Estimates for fiscal year 2011,* Ernst & Young/COST (July 2012).

5.4 Taxes and Economic Development: Do taxes affect Business Activity?[40]

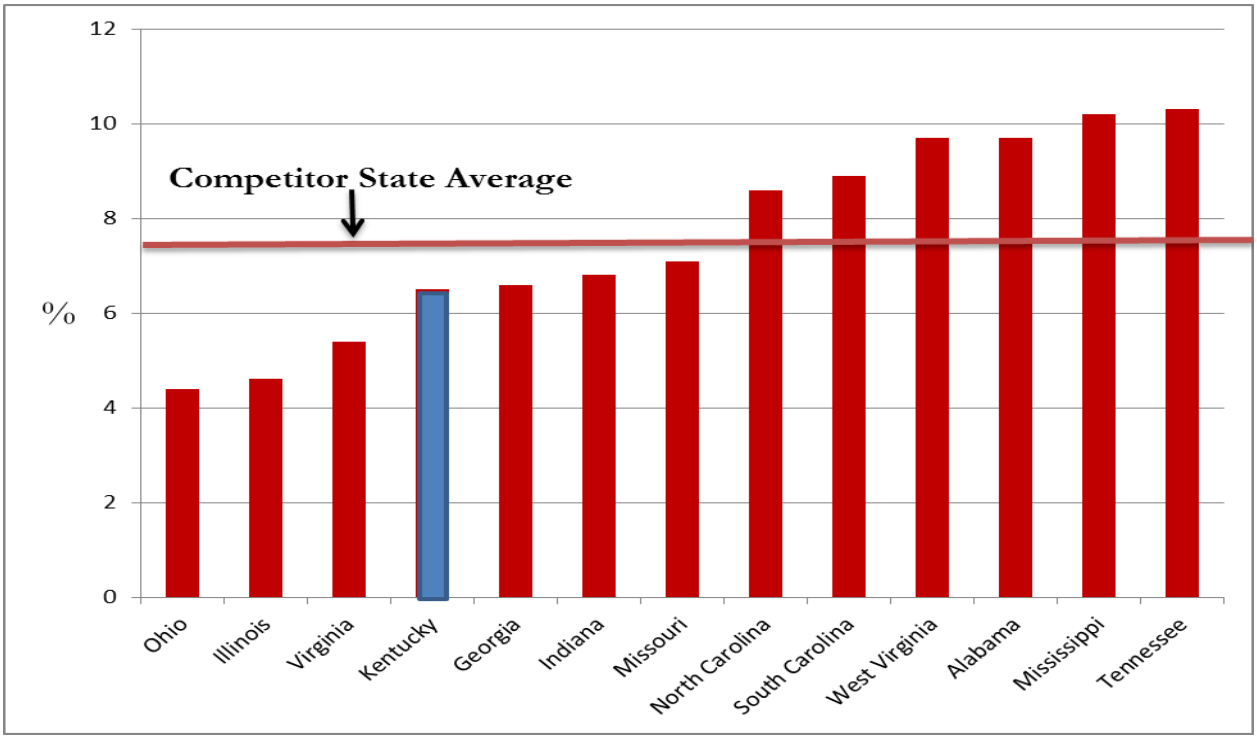
In this section, we have compared both Kentucky's economic growth and the tax burden it imposes on burden with those of its competitor states. In Section 2 we provided broader comparisons of its tax rates and structure with those of its competitors. Given both comparisons in economic growth and taxes, it important to understand to what extent the two are related. More specifically, do taxes affect business activity?

The answer to this question has been the topic of hundreds of studies by economists during the past forty years. Obviously, we do not intend to review this myriad of studies but instead summarize the results focusing on relatively more recent studies. Based on the earliest studies of taxes and

[40]This section of the report draws heavily on William H Hoyt and John Garen, "Fiscal Policy and Local Economic Development, National Center for Real Estate Research, Washington, DC (July 2005).

business activity, the answer to this question would be ambiguous. However, the answer from most recent studies, employing more sophisticated analysis, better data, and accounting for the role of public services, is yes – taxes do affect the level of employment, employment growth, and firm location among states. The question of more relevance to current research is how much do taxes matter?

Figure 5.8: Effective Tax Rate on New Investment for Selected Industries Weighted by Capital, Kentucky and Competitor States



Source: Robert Cline, Andrew Phillips, and Thomas Neubig, "Competitiveness of State and Local Business Taxes on New Investment: Ranking States by Tax Burden on New Investment," Ernest & Young and COST (April 2011).

Three reviews[41] of this literature provide a summary of the magnitude of the impact of taxes on economic activity using the concept of *elasticity* as was used in our examination of the growth of tax revenues relative to growth in personal income. Here elasticity tells us the percentage change in our measure of business activity (employment, gross state product, birth of firms) as a result of a one percent increase in taxes. Thus an elasticity of -0.5 means that a 10 percent increase in taxes reduces business activity (as measured) by 5 percent.

Table 5.2 summarizes the findings of more recent studies of the impacts of taxes on business activity. The table provides a number of different measures of business activity that have been examined in the literature with the most common being employment or employment growth. Studies have

[41]In summarizing the findings of this extensive literature we draw heavily on three review studies: Timothy Bartik *Who Benefits from State and Local Economic Development Policies?* W. E. Upjohn Institute for Employment Research, Kalamazoo, MI (1991); Michael Wasylenko "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review,* (March/April 1997); Joseph Phillips and Ernest Goss "The Effect of State and Local Taxes on Economic Development: A Meta-Analysis," *Southern Economic Journal* (1995).

generally focused on the impact of all taxes, generally measured as a tax revenue as share of gross state product or per capita or employee, or business taxes on business activity. The first number in the each cell is the average elasticity found in the studies with the numbers in parenthesis giving the range of estimated elasticities.

A few comments and explanations: while there is a great deal of variation in the reported elasticities it appears that employment and investment are the most responsive to total taxes though manufacturing employment is much less responsive than aggregate employment. Note that we report separately "All Measures" and "All Measures controlling for Public Services" and "Employment or Employment Growth" and "Employment controlling for Public Services". This distinction is made because economists understand that increases in taxes also mean increases in government expenditures on services including higher education, K – 12 education, infrastructure, and recreational facilities. By directly increasing productivity through expenditures on education and infrastructure, the business climate improves. Indirectly, increases in public services that enhance the quality of life make the state more attractive to potential employees of firms. Of course, some government expenditures do neither. Most studies of the impact of taxes on business activity that have been done by economists have attempted to isolate and separate the effects of the taxes and the use of the revenues from these taxes. Then in *Table 5.2* "All Measures controlling for Public Services" and "Employment controlling for Public Services" should be interpreted as the impact of taxes in the absence of any productive use of the tax revenue from these taxes. "All Measures" and "Employment or Employment Growth" include the results of studies that do not isolate the effects of the taxes and the expenditures financed by the taxes. Not surprisingly, then, when, the impact of taxes is isolated from how their revenues are used, taxes are found to have a greater negative impact on business activity with an estimated average elasticity of -.78 – a 1 percent increase in taxes decrease employment or employment growth by .78 percent.

Table 5.2: Estimated Tax Elasticities from Inter-State Studies

Measure of Business Activity	Tax Elasticity for Total Taxes	Tax Elasticity of Business Taxes
All Measures	-.22 (-.73 to -.04)	
All Measures controlling for Public Services	-.33 (-.88 to -.07)	
Employment or Employment Growth	-.58 (-.85 to 0)	-.11 (-.16 to 0)
Employment controlling for Public Services	-.78 (-.81 to -.75)	
Manufacturing Employment	-.10 (-1.54 to .05)	(-.26 to 0)
Investment	-.60 (-1.02 to .54)	-.20 (-.36 to -.10)
Gross State Product	-.07 (-.88 to .27)	-.14
Birth of Manufacturing Firms	-.18 (-.4 to 0)	-.20 (-.157 to .6)

6. Simplicity and Compliance Issues in the Kentucky Tax System

Somewhat ironically, simplicity and compliance might be two of the more complex issues to address when considering reforming state taxes. In this section, we summarize some of the limited evidence on the administrative and compliance costs of the individual income tax and the general sales tax, provide a general discussion of how the changes in tax structure might affect simplicity and compliance.

6.1 Simplicity and Compliance in the Income Tax

In thinking about simplicity of a tax code it is useful to attempt to quantify the costs of administrating and complying with the code. There are no estimates of either administrative or compliance costs of the Kentucky individual income tax code. There are, however, estimates of the costs of compliance with the federal income tax code as well as estimates of the IRS costs of administration.

Slemrod (2005) reports that the IRS has a ratio of administrative costs to revenue collections of 0.52% or $0.52 per $100.[42] While administrative costs of the Kentucky state income tax, per dollar of revenue, likely to be higher than for IRS administrative costs of administrating the federal income tax it is probably still insightful.

More substantial are the costs associated with compliance of the federal income tax. Numerous studies have attempted to estimate these compliance costs. Critical to these estimates is an estimate of the amount of time undertaken in compliance including completion of forms and maintenance of records. Additional costs include tax planning and tax audits and litigation. J. Scott Moody, Wendy P. Warcholik, and Scott Hodge estimated the compliance costs for the federal income tax in 2005 at $265.1 billion ($2005) or 22.2% of federal income tax revenue.[43] Their estimate of the time spent in compliance was 6 billion hours. This figure is probably at the extreme – in an earlier Tax Foundation study, J. Scott Moody estimates individual filing costs in 2002 of $104 billion when evaluating time used in compliance at $30 an hour.[44]

While these compliance cost estimates are for the federal income tax, given the similarity of the Kentucky income tax to the federal tax, they suggest that high compliance costs for the Kentucky tax as well. Then some possible options that might be considered to simplify and reduce compliance costs of the Kentucky individual income tax are:

- **Significant Increase in Standard Deduction and/or Exemptions.** Perhaps the most effective method of simplifying taxes is not having households file taxes. Major federal reforms, most notably the Tax Reform Act of 1986, did simplify, not because it reduced the number of tax brackets from 15 to 3 but because the significant increase in the standard deduction dramatically increased the number of households who did not need to file.

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[42]See Joel Slemrod, "The Economics of Tax Evasion," *The Journal of Economic Perspectives* (Winter 2007). Reported costs are from an international comparison done by the OECD.

[43]J. Scott Moody, Wendy P. Warcholik, and Scott Hodge. "The Rising Cost of Complying with the Federal Income Tax," Special Report #138, Tax Foundation (December 2005).

[44]J. Scott Moody. "The Cost of Complying with the Federal Income Tax," Tax Foundation Special Report 112, (2002).

- **Elimination of Itemized Deductions**. This is a central tenant of the flat tax or "post card" tax.[45] While again, a single rate is argued as simplifying, in fact, taxpayers do not determine their tax payment by calculating a formula involving their marginal tax rates but use a table of tax payments. The complexity of the table is unaffected by the number of tax brackets. However, the flat tax does advocate for elimination of deductions. Much of the complexity and time costs involved with the individual income tax involve calculation of deductions. Again, a larger standard deduction or restricting itemized deductions would reduce the number of taxpayers who would engage in calculating itemized deductions. Currently ten states do not have itemized deductions.[46]
- **Reduce marginal tax rates.** This would probably have minimal impact on simplicity but should increase compliance. If there is less to be gained by underreporting, the incentive to do so should be decreased. International evidence, on the "tax underreporting gap", shows mixed evidence. The gap estimated for the federal individual income tax of 17% is above the UK value-added tax and Sweden both nations with higher marginal tax rates. Another indication of the extent of noncompliance is the size of the shadow economy.[47] The United States, among the OECD countries has the smallest shadow economy with the highest being Italy and Greece, very high tax countries.

6.2 Simplicity and Compliance in the Sales and Use Tax

Tax collection from businesses, rather than households, is likely to be much lower cost. Of course, as discussed in *Section 4*, collecting taxes from businesses does not change the incidence of sales taxes away from the consumer. In thinking about expanding a sales tax, simplicity, administrative costs, and compliance are all important considerations.

Evidence on the actual costs of administrating a state general sales tax are limited. Based on surveys of eight states from 1991 to 1993, John F. Due and John L. Mikesell estimated a cost of $0.41 to $1.00 of administrative costs per $100 of revenue collected.[48] In an examination of the "Fair Tax," a federal sales tax in which the tax is collected by state governments, David G. Tuerck, Paul Bachman, and Alfonso Sanchez-Penalver estimate a collection cost of $0.80 per $100 of revenue collected.[49] Of course, what is unclear from this type of analysis is how much additional administrative costs are incurred.

Of course in addition to the administrative costs, the general sales tax imposes additional costs on retailers and other businesses subject to collecting the sales tax. A study by PricewaterhouseCoopers found that in 2003 the average annual state and local retail sales tax compliance costs were $3.09 for $100 collected with these costs being much greater for small businesses than large retailers.[50]

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[45]The scholarly advocates of the flat tax are Robert E. Hall and Alvin Rabushka, *The Flat Tax,* Hoover Institute Press (1985).

[46]States without itemized deductions in 2011 are Connecticut, Illinois, Indiana, Michigan (no standard deduction as well), New Hampshire, New Jersey, Ohio, Pennsylvania (no standard deduction), Rhode Island, Tennessee, and West Virginia (from Rick Olin, Individual Income Tax Provisions in the States," Wisconsin Legislative Fiscal Bureau (July 2012).

[47] See Slemrod (2007).

[48]John F. Due and John L. Mikesell. *Sales Taxation,* 2nd Edition Washington, DC Urban Institute Press (1994).

[49]Daviv G. Tuerck, Paul Bachman, and Alfonso Sanchez-Penalver. "Tax Administration and Collection Costs: The Fair Tax vs. the Existing Federal System," The Beacon Hill Institute at Suffolk University (September 2007).

[50]PricewaterhouseCoopers. "Retail Sales Tax Compliance Costs: A National Estimate," Volume One: Main Report (April 2006)

If additional goods and services are to be included in the sales tax base, the ability of Kentucky residents to be able to purchase these services from out-of-state vendors including online purchases is critical. While Kentucky has a use tax evidence suggests that few taxpayers report amounts close to their actual out-of-state purchases subject to Kentucky taxes. Effective compliance to the sales tax requires that the tax be placed on goods and services for which out-of-state purchases are limited or enforcement of the use tax is increased.

The administrative costs of expanding the sales tax base are lower if they are applied to services and goods that are already collecting and reporting sales tax revenue on other purchases made at the business. Thus, for example, an automotive repair shop is providing both services (labor) and tangible products (oil, parts) will already being paying the tax on the parts and other products sold to the customers. As the PricewaterhouseCoopers study suggests, compliance costs will be much lower for larger retailers and retailers from whom taxes are already collected.

6.3 How Does Kentucky Compare in Tax Administration?

The Council on State Taxation has intermittently produced studies evaluating state tax administration. In a 2010 report, COST evaluates state governments on tax appeals and procedural requirements.[51] The criteria for an effective and independent appeals process includes: the appeals forum must be truly independent; taxpayers are not forced to post bond prior to an independent hearing; the record for further appeals must be established before an independent body; and the arbiter at the hearing must be well-versed in the intricacies of state tax laws and concepts. The procedural elements evaluated consider whether the state has adopted: even-handed statutes of limitations for refunds and assessments; equalized interest rates on refunds and assessments; due dates for corporate income tax returns at least 30 days beyond the federal due date; adequate time to file a protest before an independent dispute forum; reasonable and clearly defined procedures for filing amended state income/franchise tax returns; and any additional ineffective, burdensome or inequitable practices.

COST undertook a similar survey of practitioners and property tax administrators to assess the administration of the property tax. In this case the criteria was based on: whether the property tax system had standardized filing, remittance, and appeal procedures throughout the state; whether the appeal process for disputes was before an independent tribunal; and whether the property tax burden was balanced and uniform and not shifted onto business taxpayers.[52]
Results of these scorecards for Kentucky and its competitors are reported in *Table 6.1*. Based on a survey of practitioners and state tax administrators, Kentucky received a "B" in the scorecard on appeals and procedural requirements and a "B+" for property tax administration, one of the 5 top ranked states. Both grades are the highest among the 13 states in both categories.

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[51]Douglas L. Lindholm and Fredrick J. Nicely. "The Best and Worst of State Tax Administration: Cost Scorecard on Tax Appeals & Procedural Requirements, COST (February 2010).
[52]Fredrick J. Nicely and Douglas J. Turner. "The Best and Worst of State Tax Administration: Cost Scorecard on State Property Tax Administrative Practices, COST (May 2011).

Table 6.1: COST Grading of States Tax Appeal & Procedures and Property Tax Administration

State	Appeals & Procedure	Property Tax
Alabama	D	C-
Georgia	C-	B+
Illinois	D	D-
Indiana	B	C-
Kentucky	B	B+
Mississippi	B+	C-
Missouri	B	C-
North Carolina	B-	B-
Ohio	B	B-
South Carolina	B	C-
Tennessee	C+	C-
Virginia	A-	C-
West Virginia	B	C-

Source: Douglas L. Lindholm and Fredrick J. Nicely. "The Best and Worst of State Tax Administration: Cost Scorecard on Tax Appeals & Procedural Requirements, COST (February 2010) and Fredrick J. Nicely and Douglas J. Turner. "The Best and Worst of State Tax Administration: Cost Scorecard on State Property Tax Administrative Practices, COST (May 2011).

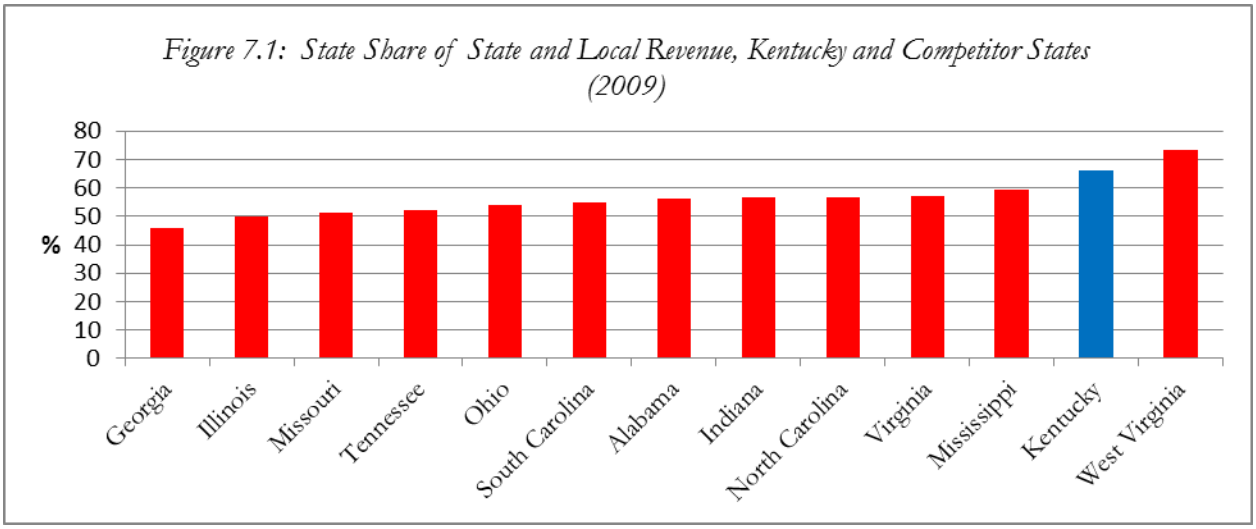
7. Local Tax Issues

While the Commission is primarily focused on issues related to state taxes in Kentucky, proper evaluation of the state tax system cannot ignore the structure of local taxes in Kentucky nor should any reform efforts ignore the ramifications of changes in the state tax structure on local finances.

In this section, we briefly review and put in context the relationship between state and local taxation in Kentucky. As we discussed in Section 2, Kentucky is heavily reliant on the state government as a source of both revenues and expenditures. In addition, the structure of local taxation in Kentucky is in some ways very different from that of its competitors.

7.1 Local Taxation in Kentucky

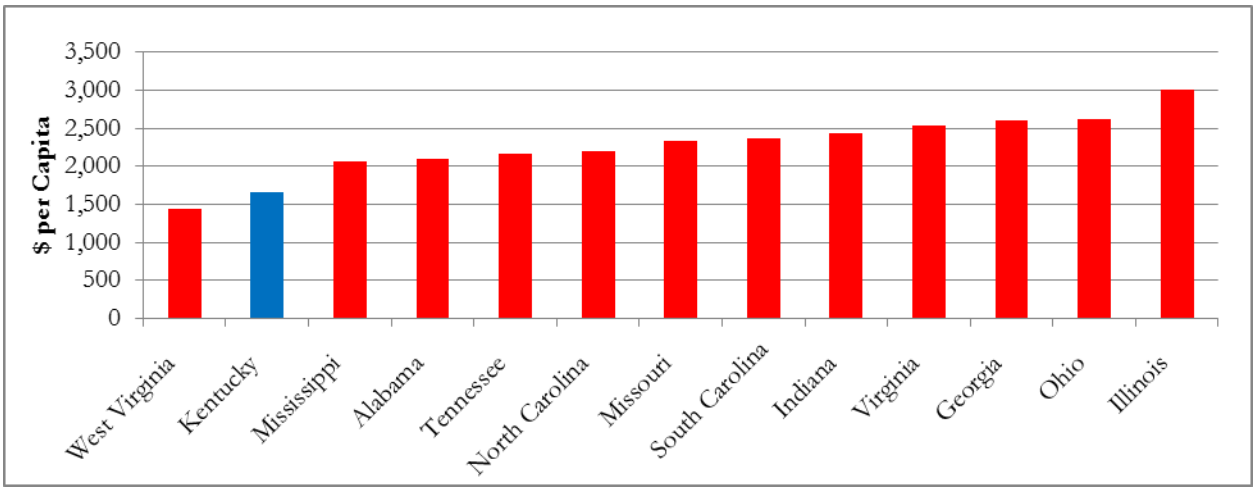
To understand local taxation in Kentucky, first consider what role it plays relative to state taxation. In *Figure 7.1* we show the state share of state and local revenue in Kentucky and its competitor states for 2009. As the figure shows, relative to most of its competitors, revenue collection is extremely centralized in Kentucky. Not surprisingly, as shown in *Figure 7.2,* Kentucky has the second lowest local revenue per capita among its competitors.



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

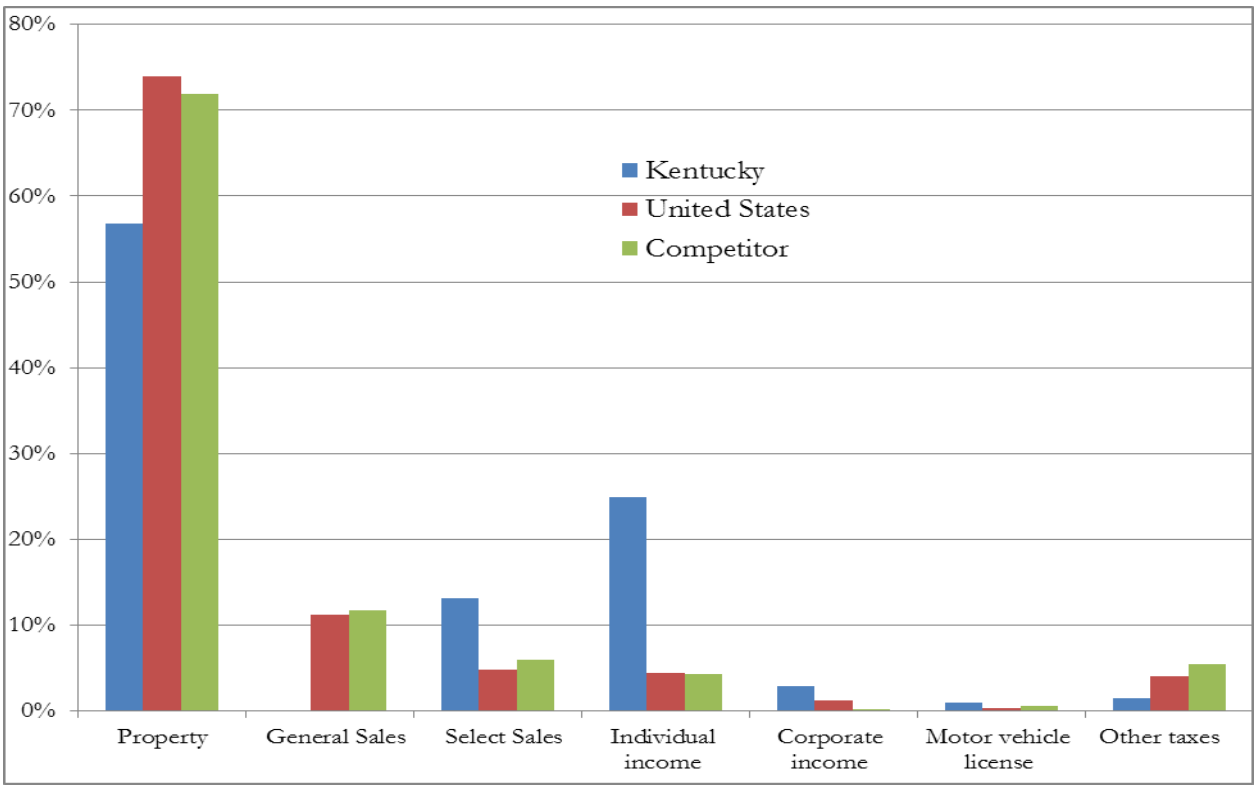
In *Figure 7.3* we compare the distribution of taxes of local governments for Kentucky, its competitor states, and the United States average. As the figure shows, the average distribution of tax revenue for Kentucky's competitor states is quite similar to the average of all states. Both collect over 70% of revenue from the property tax, about 11% from local general sales taxes, and 4% from local income taxes. In contrast, Kentucky collects less than 60% of its local revenue from the property tax, 0% from general sales taxes, and 25% from local income taxes. Kentucky is only one of 15 states with local income (occupational license) taxes and only one of 15 states without a local sales tax option.

Figure 7.2: Total Local Revenue (2009) (per Capita)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

Figure 7.3: Share of Revenue Collections by Tax for Local Governments, Kentucky, Competitor States, and United States Average (2009)



Source: Authors' calculations from 2009 State and Local Government Finance Summary Report, United States Census Bureau, U.S. Department of Census, http://www.census.gov/govs/estimate/.

7.2 Implications of Kentucky's Local Tax Structure on Local Finances

If, in periods of restricted state budgets, there is a view that local governments in Kentucky will need to be more responsible for responsible for their own funding, Kentucky's current local tax structure might impose some serious constraints on local funding. Property taxation rates and levy limits in Kentucky are constrained by HB 44 and evidence suggests that these property tax limits can severely limit local government spending.[53] In addition, there is evidence that businesses have become much more effective in finding ways to avoid paying property taxes further diminishing growth in this base.

A tax base Kentucky relies on heavily, unlike almost all other states, is local income taxes. In the case of Kentucky, it is a local occupation license tax that is imposed on individual earnings at the site of employment. The tax rate, when all local taxes are aggregated, exceed 2% in both Jefferson and Fayette counties with this rate applied from dollar zero of earnings. Given the relatively high rates of state income taxation in Kentucky, particularly when compared to that found in bordering states, additional taxes on income and earnings might prove to put Kentucky in a serious competitive disadvantage.

Given the limited opportunities for growth in the property tax and concerns about competitiveness with regard to the occupational license tax, if local governments are to increase their own revenues, more flexibility in revenue sources, most likely through a local sales tax option might be advisable.

[53]See William H. Hoyt, Paul A. Coomes, and Amelia M. Biehl. "Tax Limits and Housing Markets: Some Evidence at the State Level," *Real Estate Economics,* January 2011, 39(1).

Section 8: Tax Reform Efforts in Kentucky and Competitor States

8.1 Recent Tax Changes in Competitor States

This section examines tax changes among Kentucky's competitor states since 2007. [54] Nearly all of Kentucky's competitor states have made tax policy changes, and some have made many, but only the larger adjustments are discussed. We do not refer to all of these as reforms, since in many cases they do not represent what we consider improvements in the tax structure. Ohio's 2005 major tax structure change is discussed first because it represents the biggest revisions by any competitor state in recent years. The changes included: a) phasing out the business tangible personal property tax, b) phasing out the corporate franchise tax, c) phasing in the Commercial Activity Tax (CAT), d) reducing marginal rates in the individual income tax, e) reducing the sales tax rate, f) increasing the cigarette tax rate and g) repealing the 10 percent rollback on business real property tax. Notable on this list are a significant reductions in individual income tax rates to a maximum of 5.925 percent, introduction of the CAT (a 0.26 percent tax on gross receipts), and reduction in the property tax on business tangible personal property. The CAT was intended to replace the tax on a number of the business taxes, including the franchise and personal property taxes. The changes have resulted in a lower role for personal income taxes, a business tax increase through the CAT, and a decrease in taxes relative to the economy.

Several of the states, including Georgia and North Carolina, either had a tax commission or are considering having a tax commission, but none of the states have enacted policy change based on recommendations of a tax commission since 2007. A number of other changes have taken place across competitor states, with most of them being rate changes. Illinois temporarily increased the marginal individual income tax rate from 3 percent to 5 percent for four years beginning in 2011 and the corporate income tax rate from 4.8 to 7.0 percent for four years. Illinois also conformed the state corporate income tax to the federal tax code which resulted in an estimated $600 million loss in tax revenues. West Virginia also brought income taxes into conformity with IRS code. North Carolina temporarily allowed a 1 percent sales tax rate increase and imposed an income tax surcharge and then allowed both to expire. South Carolina (eliminated the sales tax on food), Tennessee and West Virginia continued to phase down the sales tax rate on food for consumption at home. Tennessee also began a phase out of the estate and inheritance tax by increasing the exemption and Virginia eliminated its estates tax. Several states, including Illinois, enacted tax amnesties. At least four states, including Indiana, Mississippi, South Carolina and Tennessee, raised their tobacco tax rates. Small expansions in the sales tax base occurred in several states. For example, Illinois added coffee, candy tea and grooming and hygiene products. Ohio (new casinos) and Indiana (slot machines at pari-mutuel horse racetracks) also enacted new or expanded taxes on gambling. Alabama and Georgia made no significant tax structure changes in recent years.

8.2 Prior Tax Reform Initiatives

Table 8.1 provides a chronological list of previous studies of the Kentucky state tax system with reference to the sponsoring agency and when completed by an independent consultant, the consulting agency or individual.[55]

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[54] Health care or hospital assessments and unemployment insurance are not discussed here.

[55] This and the following sections rely heavily on Greg Harkenrider, "Prior Tax Reform Initiatives," Presentation to the Governor's Blue Ribbon Commission on Tax Reform, April 2012.

Table 8.1: Summary of Previous Studies of Tax Reform

Date	Title	Sponsoring Agency/Body or Consultant
November 1982	A Proposal to Reform and Simplify the Kentucky Tax System (A Flat Rate Individual Income Tax and a Corporate Business Activity Tax to Replace Eight Existing Taxes)	Revenue Cabinet
April 1983	A Proposal to Reform and Simplify the Kentucky Individual Income Tax System	Revenue Cabinet
February 1990	Governor Wilkinson's Revenue Revitalization Program: Questions and Answer	Finance and Administration Cabinet
November 1995	A Blueprint for Comprehensive Reform	Kentucky Commission on Tax Policy
December 1999	A Comparative Analysis of Kentucky's Tax Structure	Barents Group
December 2001	Financing State and Local Government: Future Challenges and Opportunities	Kentucky Long-Term Policy Research Center
February 2002	Report to the Sub-Committee on Tax Policy Issues	State Legislature/William F. Fox
January 2003	Securing Kentucky's Future	Patton Administration
November 2004	Kentucky's Economic Competitiveness: A Call for Modernization of the State's Fiscal Policies	Paul Coomes
January 2005	Governor Fletcher's Jobs and Opportunity Bipartisan Solutions (JOBS) for Kentucky	State Budget Director's Office
June 2006	Final Report of the Task Force on Local Taxation, House Bill 272	Legislative Research Commission

Source: Greg Harkenrider, "Prior Tax Reform Initiatives," Presentation to the Governor's Blue Ribbon Commission on Tax Reform, April 2012.

A summary of some of recommendations made in these studies and the legislative impact is found in *Table 8.2.*

Table 8.2: Recommendations of Previous Tax Reform Studies

Recommendation/Option	Recommending Study	Legislative Impact
Income Tax Recommendations		
Adopt Federal AGI as starting point for computing the Kentucky tax base and add or subtract specific items to obtain Kentucky taxable income	All studies	Kentucky adopted federal AGA with additions and subtractions
Update to Internal Revenue Code (IRC), eliminate the federal tax deduction, and implement a low income tax credit	Wilkinson Proposal	IRC updated to December 31, 2006, federal tax deduction is eliminated, the low income tax credit implemented
Adopt federal filing status	Commission on Tax Policy	No Action
Adopt federal standard deduction, personal exemptions, and eliminate low income credit	Commission on Tax Policy	No Action
Reduce or eliminate the individual income tax	Paul Coomes	An additional bracket at 5.8% is added; top rate remains at 6%
Increase lowest bracket of the low income credit to exclude from tax person whose income is at or below $12,000 and adjust other brackets	JOBS for Kentucky	Expanded and modified based on family size
Reduce the top rate of tax to 5.68%	JOBS for Kentucky	None
Sales and Use Tax Recommendations		
Impose tax on unbundled natural gas transactions and dot.com affiliates of Kentucky retailers	Governor Patton Administration	Implemented
Join Streamlined Sales and Use Tax Initiative	Governor Patton Administration	Implemented
Limit vendor compensation at $1,500 per reporting period	Governor Patton Administration	Implemented
Raise the tax rate to 7%, legalize Video Lottery Terminals, then roll-back the sales tax to 6% after 2 years	Governor Patton Administration	No Action
Eliminate the tax on switch access fees paid by communications companies	Governor Patton Administration	Implemented
Assess sales tax on DBS services at a 7% rate	Governor Patton Administration	Implemented (2005)

Table 8.2 (Continue)

Recommendation/Option	Recommending Study	Legislative Impact
	Excise Tax	
Increase tax on cigarettes	Report to Sub-Committee on Tax Policy (Fox) Securing Kentucky's Future Solving Kentucky's Fiscal Crisis JOBS	Implemented
Impose or raise tax on other tobacco products	Report to Sub-Committee on Tax Policy (Fox) Securing Kentucky's Future Solving Kentucky's Fiscal Crisis JOBS	Implemented
	Property Taxes	
Freeze the state rate on Real Property	Report to Sub-Committee on Tax Policy (Fox) Securing Kentucky's Future Solving Kentucky's Fiscal Crisis	No Action
Calculate the state real property tax limit by excluding new property before the 4% limit is imposed	Report to Sub-Committee on Tax Policy (Fox) JOBS	No Action
Eliminate of Personal Property Taxes	Report to Sub-Committee on Tax Policy (Fox) Securing Kentucky's Future Solving Kentucky's Fiscal Crisis	No Actions
Eliminate Property Taxes on Intangible Property	Securing Kentucky's Future Solving Kentucky's Fiscal Crisis JOBS	

Source: Greg Harkenrider, "Prior Tax Reform Initiatives," Presentation to the Governor's Blue Ribbon Commission on Tax Reform, April 2012.

8.3 The Evolution of the Kentucky Individual Income and General Sales Tax

8.3.1 The Individual Income Tax

The Kentucky individual income tax was passed and became law in 1936. It had a graduate scale with rates ranging from 2% to 5% for incomes of $5,000 and beyond. In 1950 the higher marginal rate was increased to 6% for incomes of $8,000 and above. This rate did not change until 2005 when the rate decreases to 5.8% for incomes between $8,000 and $75,000.

8.3.2 The General Sales Tax

The general sales tax was imposed in 1960 with a rate of 3%. Base narrowing began in 1966 with food and prescriptions eliminated in 1972. The rate increased to 5% in 1968 and 6% in 1990.

9. Options for Tax Reform

Our review of the Kentucky's current tax system has focused, as we were charged, on the adequacy, elasticity, fairness, competitiveness, and simplicity and compliance of the system. This review identified a number of potential concerns with our current system touching on all of these issues as well as inefficiencies associated with the current system.

Here we do not attempt to identify or recommend any one reform package. Instead, we offer a number of options for reform. We have several reasons for refraining from forwarding any single plan. First, as we have made clear in our earlier discussion, we can effectively describe how to think about adequacy or fairness but the decision on whether the tax system is adequate or fair is in the eye of the beholder. On these issues, we have merely tried to convey information to the Commission that we feel will be valuable to assist them in addressing issues of fairness and adequacy.

Second, by providing a number of options we feel that the Commission gets a better idea of some the alternatives and possibilities that might be consider, perhaps some of our options, or perhaps options they develop based on some options we may have suggested.

Finally a single plan should be a politically viable plan. As we are not politicians nor have we been charged to write actual legislation, some of the options we have proposed may be less politically viable than others. This is something that would be difficult for us to judge and not something we want to attempt. However, while the options we suggest have not been screened through a political filter, it is worth noting that every option we propose is one being done by at least one of our competitor states.

Given that we offer a number of options for a number of different tax instruments, are there any broad themes that emerge from these options? We believe that both the examination and the development of our options suggest two themes: options that broaden the tax or shift taxation from labor and capital to consumption. Many of the options effectively do both.

A Broader Tax Base

While we discuss the benefits and costs of each option in more detail later, a broadening a tax base addresses a number of concerns:

- a broader tax base will generally be more elastic;
- a broader tax base will allow for lower tax rates, significantly reducing the inefficiencies associate with taxes;
- a broader tax base will generally reduce differences in tax treatment of households or firms in similar economic conditions;

and

- a broader tax base may simplify tax reporting and increase compliance.

A Shift from the Taxation of Labor and Capital to Consumption

As discussed in *Section 4,* while taxes may be collected from businesses, only people, not businesses pay taxes. Taxes on businesses may be shifted forward to the consumer of their products in the form of higher prices; back to labor in the form lower wages; or to the owners of capital in terms of a lower rate of return on their investment. While it is tempting to think taxes on Kentucky businesses are exported to out-of-state consumers of Kentucky goods or out-of-state investors, we should be skeptical to the extent this is possible. Competitive markets will require that Kentucky goods will need to sell at the prices of goods produced elsewhere and investors can search the world for investment opportunities. Thus it is most likely that taxes on Kentucky businesses will stay in Kentucky and most likely reducing labor earnings and the return on capital in Kentucky.

The advantages of more reliance on taxation of consumption and less on business capital and labor earnings include:

- increase Kentucky's competitive position and employments for employment in Kentucky by making it more attractive for firms to locate and invest in Kentucky;
- reduce compliance costs for firms engaged in business in Kentucky

Each of these options has been scored with the assistance of the Commonwealth of Kentucky Governor's Office for Economic Analysis and the Department of Revenue -- meaning that the impact of the option on revenue is estimated given other current tax policies including tax rates. While our base-broadening options are associated with a revenue increase it is important to understand that we are not suggesting that these options are the only ones that should be considered if revenue is to be increased or that revenue should be increased. Gains to the economy will occur if these adoptions are adopted and rates, then, can be reduced so as to maintain revenues at the desired level.

While many of the options for reform of a tax are mutually exclusive the effectiveness and desirability of many of the options will depend on what other options are adopted. It is worth noting that while some of these are unique and perhaps even radical options for Kentucky, each of the options is a tax policy in at least one of Kentucky's competitor states.

The ordering of the options is not intended to represent any ranking or recommendation. Instead, we begin with options for the largest source of revenue for the state, the individual income tax, and then order each of the taxes based on its share of revenue. The options for each of the tax are generally ordered based on what the magnitude of the change in the tax, from minor reforms to the existing structure to sometimes an extremely different structure. In the remainder of this section we outline the specifics of our tax reform options.

9.1 Individual Income Tax Options

The individual income tax is a major source of state revenue in Kentucky and provides a mechanism to alter the distribution of tax payments among Kentucky's residents. For both these reasons and others it is important to have an income tax that is efficient, transparent, and fair.

9.1.1 Concerns about and Issues regarding the Individual Income Tax

Before discussing options for the individual income tax, a few potential concerns with Kentucky's current tax, discussed at length in earlier sections, are worth restating:

- **The individual income tax is complex with high compliance costs.** There is no specific study of which we are aware on Kentucky's individual income tax but some of studies on the U.S. federal income tax reviewed in *Section 6,* the costs of compliance are likely to be high. Compliance costs, the time and effort to complete the form, primarily arise from efforts to determine and allocate taxable income and to determine itemized deductions. To the extent our code conforms with federal code, these costs are reduced. However, our very low standard deduction ($2,240) increases both the number of households filing taxes and itemizing deductions, both of which increase compliance costs.

- **Income tax burdens for low-income households are higher than in competitor states.** How much this should be a concern probably depends on views of what, in terms of vertical equity, is a fair distribution of the income tax burden. The issue is not for the lowest income households but for those with taxable incomes in the range of $20,000 - $30,000. Given the low standard deduction, small exemptions (in form of tax credits) and the minimal amount of income subject to low marginal tax rates (5.8% MTR starts at $8,000) lower income households in Kentucky, relative to the competitor states, can pay a relatively significant share of their income in taxes. It should be noted that for the lowest income households ($10,000 or less), Kentucky's income taxes are as low as or lower than its competitor states but at $25,000 they are an additional 1.5% of income. The low tax burden on the lowest income households is probably attributable in large part to the *Family Size Tax Credit*.

- **The high marginal and average tax rates reduce competitiveness.** As shown in *Section 4,* with the exception of the lowest income brackets, individual income taxes are higher than the competitor states by 1% – 2 % of income. This is a particular concern along Kentucky's borders where much of economic activity is located and given that several states have significantly lower income tax burdens (Ohio, Indiana, and Tennessee). For states with reciprocity, it is possible for households employed in Kentucky to reside in Indiana or Ohio and pay Indiana and Ohio taxes. Coomes and Hoyt (2008) and Hoyt (2011) find evidence of this occurring. More generally, the voluminous literature on taxes and business activity reviewed as in *Section 5* suggests taxes on individuals and not just business taxes will adversely affect business activity.

- **Differential treatment of income and itemized deductions.** Income tax liabilities among households with similar incomes can differ for a number of reasons but two of the major reasons are differences in the treatment of income and differences in the amount of itemized deductions. Some differences in tax treatment arise because of the distinction between realized and unrealized increases in net worth and deferred income. The federal code does not include compensation in these forms when the income is received but taxes it when it is realized. In Kentucky, some pensions and retirement savings vehicles such as 401K are not taxed upon either receipt or realization.

  Itemized deductions, with the one of greatest magnitude being the mortgage interest deduction, may also result in households in similar economic circumstances paying substantially different

state income taxes based on consumption choices. Thus, homeowners will pay less in taxes than households renting who are otherwise identical for tax purposes.

- **Income taxation results in economic inefficiencies by distorting labor incentives and consumption choices.** Of course, all taxes result in some form and level of inefficiency making the issue not whether a tax is inefficient but how inefficient. The inefficiencies or distortions in behavior most associated with the individual income tax are labor disincentives and distortions in consumption choices. For state income taxation an additional concern is how the tax changes household locational decisions, that is, how it influences where a household will choose to live. While the marginal tax rates for state income taxes, including Kentucky's, are low when compared to the federal rates, these rates are in addition to the federal rate. As discussed in *Section 1,* increases in rates are much more distortionary the higher the rate – thus the distortion from a rate of 6% in addition to a 31% federal marginal tax rate is much more distortionary than a 6% rate alone.

  We suggested that itemized deductions might lead to horizontal inequities. They also effectively subsidize the consumption of the deductible expenditures. Thus housing consumption is subsidized because of the deductibility of the mortgage interest, making the cost to the taxpayer of housing less than its actual cost. The largest tax expenditure is not the mortgage interest deduction but employer contributions for medical insurance and medical care. This is a subsidy on health insurance, which many might argue is very desirable. However, it is also a subsidy on elective procedures that are covered as well as routine and predictable services.

- **Income Tax Revenue is not keeping pace with personal income.** As discussed in *Section 3,* the revenue elasticity of the income tax was estimated to be 0.82 between 2000 and 2008. In other words, a 10% increases in personal income will only increase individual income tax revenues by 8.2%. If the desired level of expenditures is considered to be a relatively constant share of personal income, revenue collections need to be as well. This is not the case for revenue from the individual income tax.

9.1.2 Options for Reforming the Individual Income Tax

How might at least some of the issues regarding the individual income tax be addressed by some reforms to it? Here we offer a number of alternative options, some of which are mutually exclusive and some of which can be jointly undertaken. The detail to which we outline these options varies among options and all can be modified. Broadly, most of the options we propose broaden the tax base.

Broadening the income tax base addresses several concerns about the income tax and Kentucky tax system. First, the broader the base for any tax, the lower the rate needed to raise a given amount of revenue. As we discussed in *Section 1,* the inefficiency associated with a tax increases dramatically with the tax rate. Given the rather high marginal tax rates on earnings already imposed in Kentucky we believe this is an important consideration. Second, a broader tax base that includes more income is likely to be more elastic. Broadening the tax base, at least as we propose, will also result in households with similar incomes having less potential variation in their tax burdens than they do under the current system. Finally, a broader tax base provides fewer opportunities for taxpayers' to

engage in behavior and make economic choices based on their tax consequences – behavior that is generally inefficient and makes compliance more costly.

Our purpose in offering them is not to provide a detailed plan but to provide an idea of the general nature of reforms that address the concerns about the tax system that the Committee has been charged to address.

Individual Income Tax Option 1: Conform the Kentucky individual code with the federal code

Specifically, the Kentucky code should adopt the federal definition of adjusted gross income (AGI). Itemized deductions should be patterned on federal deductions with the exception that they not include state taxes. This option will reduce complexity and increase compliance. In addition, as the federal definition of AGI is broader that the Kentucky definition. To ensure that Kentucky is not limited in determination of its own polices, it should adopt the federal code of a specific date and reconsider, when necessary, adopting federal code when it changes.

Initially this option would reduce revenue by $9.0 million annually but this would be reduced over time.

Individual Income Tax Option 2: A State Earned Income Tax Credit (EITC)

If the Commission wants to consider reducing the burden on lower income households, a *State Earned Income Tax Credit (EITC)* is one option. The *EITC,* unlike welfare and other means-test transfer programs should not adversely affect taxpayer behavior, in this case the incentives to work. While Kentucky could devise their own plan, we recommend that they follow the examples of Illinois and Indiana and "piggyback" on the federal *EITC* by offering a refundable credit that is a percentage of the federal *EITC*. A credit that is 6% of the federal credit would provide a maximum tax credit of about $300 for a single or married household with two children.

We believe that one advantage of a *EIC* over increasing welfare benefits or other transfers is that given that the *EIC* requires employment, cross-border migration to receive the *EIC* is likely to be very minimal. The same cannot be said for welfare benefits and other state aid to low income households.[56]

While there are concerns about the complexity added by the *EITC* (the *EITC* discussion in the 2011 IRS 1040 instructions is 28 pages) it should be noted that all the complications are added by completion of the federal *EITC*. As the option is to "piggyback" the state *EITC* is a simple percentage of the federal *EITC* and would one line to the form.

Finally, it should be noted that this option, like the others, should be considered in conjunction with other options. The *EITC* might be a particularly attractive option if expansions to the general sales tax, particularly the taxation of in-home food, are adopted that increase the regressivity of that tax.

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[56]Terra McKinnish. "Importing the Poor: Welfare Magnetism and Cross-Border Migration," *Journal of Human Resources,* (2005) provides evidence on this migration by examining how cross-state differences in the generosity of welfare benefits affects welfare payments in border counties.

Based calculations from the Governor's Office of Economic Analysis the estimated cost of an *EITC* that is 5% of the federal *EITC* would be $45 million in 2012.

Individual Income Tax Option 3: Increase the tax on pension and other retirement income

As discussed in our overview of both Kentucky and it competitor states' tax systems, six of our competitor states offer only minimal exemptions of pensions from taxable income. Exempting public and private pensions as well as *IRA* income is estimated by the Governor's Office for Economic Analysis to result in a loss in $145 million in tax revenue.[57]

This policy would be a dramatic change from the current exemption of $41,110 per pension recipient and would result in a tremendous increase in revenues, almost a third of current income tax collections, as well as significant changes in tax liabilities for those receiving pensions and other retirement income. A more moderate approach, along the lines of some of competitor states that offer exemptions on the order of $10,000 - $12,000 would reduce the impact of these changes on all households who receive retirement income, particularly those with the lowest incomes.

What concerns about the tax system would this change address? Some might argue that exemption of pension and other retirement income from taxation while taxing earnings is unfairly treating younger, working households who might have much higher expenses. Taxing income in retirement is likely to have less of an impact on labor incentives than higher taxes on earnings or incentives of firms to locate in the state. Some might argue that such a policy might make Kentucky a less attractive spot for retirees to live but economic research on the issue of how taxes influence locational decisions of the elderly suggests that state taxes only have limited influence on locational decisions.[58] More relevant might be concerns about the migration of the employed and the firms that employ them if revenue is collected from an alternative tax on businesses or their workers. Finally, with baby-boomers beginning to retire and therefore pensions and retirement income forming a large share of Kentucky personal income, broadening the tax base to include pension income will likely increase the elasticity of the tax base.

Individual Income Tax Option 4: Make Taxable Income equal to Federal Adjusted Gross Income (AGI) less a large standard deduction and tax credit for low-income households

While this might seem to be our most radical option for the individual income tax, in fact it is done by 10 states including Indiana, Illinois, and Ohio. This option would include pension income as taxable income as it is taxed by the federal government. It would also exclude numerous deductions and exemptions used to reduce taxable income. This modification would dramatically simplify the individual income tax. In fact, the tax could be done on a "postcard" given that households have already determined federal AGI when doing federal taxes.

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[57]See "Tax Expenditure Analysis: Fiscal Years 2012 – 2104," Governor's Office of Economic Analysis, Office of State Budget Director, Commonwealth of Kentucky(November 2011) p. 15.

[58]See Karen Smith Conway and Jonathan C. Rork. "State Death Taxes and Elderly Migration," *National Tax Journal (March 2006),* Karen Smith Conway and Andrew J. Houtenville. "Do the Elderly 'Vote with Their Feet'? " *Public Choice* (December, 1998), Karen Smith Conway and Andrew J. Houtenville. "Out with the Old, In with the Old: A Closer Look at Younger versus Older Elderly Migration." *Social Science Quarterly* (June, 2003) and Donald Bruce, William Fox, and Zhou Yang, "Base Mobility and State Personal Income Taxes," *National Tax Journal* (December 2010).

Broadening the base this dramatically would allow for significant decreases in marginal tax rates or expansions of the standard deduction. The simplest plan would be a combination of a single tax rate and a standard deduction. While Kentucky has six tax brackets, four of these brackets occur for taxable incomes of less than $8,000 and only collect $278 on the $8,000 essentially making for a phased-in standard deduction. The two brackets beyond $8,000 only differ by 0.2%. Thus, effectively, we have a standard deduction of approximately $10,000 and a single rate of approximately 6%. A single tax rate and larger standard deduction would accomplish the same objectives and be simpler.

For any revenue objective, the larger the standard deduction, the higher the marginal tax rate needs to be. Based on the current distribution of taxpayers in Kentucky, *Table 9.2* lists some possible combinations of standard deduction and marginal tax rates and the revenue. The progressivity of this tax, as measured by average tax rate, depends on the magnitude of the standard deduction – the larger the standard deduction the more progressive the tax is.

Of course, modifications to this option are certainly possible. One modification that does not add complication is to have multiple tax brackets with higher marginal tax rates at higher income levels. There is no increase in complexity because households would refer to a table (or have their taxes calculated for them). An alternative that has the same economic impact as increasing the marginal tax rate is to phase out the deduction, a characteristic of the Ohio code. Of course, a concern with the current Kentucky tax code is the high marginal tax rate (6%) for taxable income above $75,000 that combined with local income (occupational license) taxes make effective marginal tax rates above 8% in many localities in the state, including our major metropolitan areas.

Other modifications are possible as well including allowing some of the itemized deductions. This would significantly increase complexity and alter the simple relationship between a household's adjusted gross income and what it pays in taxes. Allowing, for example, the mortgage interest deduction will now mean that the taxes a household pay not only depends on its income but also whether and how much a mortgage it has.

Increasing complexity is only one of the costs of allowing itemized deduction. Another cost is how itemized deductions distort relative prices, effectively subsidizing some goods. This is particularly important for housing as the price of owner-occupied housing is effectively reduced through the deductibility of mortgage interest. This distortion, as suggested by numerous economic studies, leads to more households choosing owner-occupied housing than rental and purchasing more owner-occupied housing than they would have in the absence of this favorable tax treatment.[59] Allowing the deduction of local taxes reduces the price of tax-financed publicly-provided goods and services relative to private goods and services.[60] This might lead to higher taxes and local government expenditures than would occur in the absence of the deductibility of these taxes.

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[59]See, for example, William Hoyt and Stuart Rosenthal, "Housing Demand, Capital Gains, and Tax Reform," *Journal of Urban Economics,* 1992 ; James Poterba. "Tax Subsidies to Owner-Occupied Housing: An Asset-Market Approach," *Quarterly Journal of Economics,* 1984; and Harvey Rosen. "Housing Decisions and the U.S. Income Tax," *Journal of Public Economics,* 1979.

[60]While there have not been studies that have attempted to estimate how the deductibility of local taxes in state income tax calculations, see Harvey Rosen and Douglas Holtz-Eakin. "Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics* (May 1990) as an example of how federal income tax deductibility affects local revenues.

Finally, elimination of itemized deductions should reduce the regressivity of the state income tax. Higher income households are much more likely to itemize and have much greater itemized deductions. It should also reduce differences in taxes among households with very similar incomes but who make different consumption choices (housing, charitable contributions).

While, as we suggest, there are a number of ways in which the tax could be structured if we were to have a single 6% tax with the current system of tax credits, revenues would increase by $780 million. Alternatively, the rate could be reduced to approximately 4% without affecting revenues.

9.2 Sales Tax Options

Sales tax options are focused on potential changes in the tax base. This section generally argues that the sales tax base should be expanded to more consumer purchases and fewer business purchases.

Taxing Consumer purchases

Distortions arise because the sales tax is imposed on a narrow set of consumer purchases. Many services, prescription and some non-prescription drugs, and food for consumption at home are examples. Key effects include encouraging consumers to buy untaxed goods and services versus taxed ones and altering where people shop. Thus, granting exemptions (or not) can potentially affect decisions to purchase taxed items relative to untaxed items and to purchase items in Kentucky versus remotely. One important issue is who pays the tax—that is, are sales taxes ultimately paid by consumers through higher prices or are they borne by other possible groups–such as business owners, workers, or landowners–through lower earnings. Presumably, the sales tax should have larger effects on consumer behavior if it is borne by consumers rather than borne by others, such as business owners.

As discussed in *Section* 4, the limited evidence on the incidence of state sales taxes suggested it is shifted forward to consumers. The conclusion that consumers pay the sales tax, however, is reached for a series of standard consumer items that are likely to be purchased locally and does not necessarily apply to goods or services that can be purchased easily across state lines. The higher gross of price tax paid by consumers could cause them to shop more out of state or to buy more untaxed items and lessen the ability to pass the tax forward to consumers.

The sales tax can affect consumer behavior in two key ways, given that consumers bear the tax on local purchases. First, sales taxes can change what consumers buy since the relative price of exempt items is lower than for taxable items. The effects on behavior and tax revenues depend on how responsive consumers are to the price of the exempt versus the taxable goods. Merriman and Skidmore (2000) indirectly investigate this question as they studied how the sales tax rate has affected the allocation of expenditures between retail activity and service activity between 1982 and 1992. This is a reasonable test of the effect that sales taxes have on exempt versus non-exempt purchases since many services are exempt in most states and many goods are taxable in most states. Merriman and Skidmore find evidence that the share of the economy in the retail sector fell, and the share in the service sector rose in high sales tax rate states. This suggests, as would be expected, that sales taxes alter consumption behavior by increasing the quantity demanded for exempt items compared with taxable items. Thus, Kentucky's exemptions can be expected to shift the amount of purchases, at least to some extent.

Russo (2005) also studied the effects of having a broad based versus narrow based sales tax on economic activity. He finds no relationship between the size of the state's economy and the breadth of the base, but a broader base results in a small improvement in the overall wellbeing in the state. The broader base increases wellbeing by permitting a lower tax rate (which lessens incentives to buy those remaining exempt items) and by allowing for a relatively small set of exempt items. Kentucky's narrow base suggests it stands to gain considerably from base broadening. It should be noted that Russo observes an even larger gain for states when they combine taxing all consumption with eliminating taxation of business inputs.

Second, sales taxes can change where consumers choose to make purchases. Consumers can purchase online, via mail order, or travel to other states. In some cases the remote vendor collects the tax for Kentucky and the tax does not alter where purchases are made. But, Kentucky residents and businesses have a tax incentive to look for the vendors that do not collect sales tax for the state.[61] The use tax is owed when items are purchased remotely for use in Kentucky, but compliance with the use tax is very poor, particularly for individuals.

Research suggests that the sales tax alters where people shop. For example, Goolsbee (2000) examined the effects of sales taxes on Internet shoppers and found that higher sales tax rates increased the incentive to shop online. His analysis relied on 1997 data, which was early in the e-commerce buying age, making the results less applicable than if a more recent study were available. Nonetheless, he demonstrates that efforts to evade the tax were a significant factor in people shopping online. Also, research has been conducted on the effects that tax differentials along state borders have on where people shop, though much of the work is getting old. The research generally finds that people respond to tax differentials by doing relatively more of their shopping on the low tax side of the border. Each study concludes that high tax rates have a large effect on shifting consumers to the other side of the state border (see Fox (1986) and Walsh and Jones (1988) for examples).

Russo (2005) also examined effects of extending the sales tax to Internet sales. He finds that state economies would be slightly larger and the level of wellbeing higher if all Internet sales could be taxed. Presumably this is because the incentives to avoid the tax by purchasing out of state via the Internet are eliminated. The result is also consistent with the conclusion that a lower sales tax rate is better for the state's economy because it reduces the incentive to buy outside the state.

Taxing all consumption would be the best policy (at least from an economic efficiency perspective) if not for the administration and compliance costs of collecting the revenues, particularly on purchases from out-of-state. Taxes can be collected most effectively on Kentucky firms which can place them at a competitive disadvantage for items easily sold remotely. Thus, care must be exercised in choosing what consumption to tax.

Sales Tax Option 1: Broaden sales taxes to selected services

Four rules should guide which services should be considered for taxation:

- The services should be primarily consumed by households.
- Kentucky service producers are not adversely affected in their ability to produce for Kentucky (or out-of-state) consumers.

[61]Based on the U.S. Supreme Court ruling in *Quill, Inc. v. North Dakota*, firms can only be required to collect the tax in states where they have physical presence. Firms can choose to voluntarily collect and remit the tax for states.

- The services compete directly with other taxed goods or services.
- Administration and compliance costs are not prohibitively high. These costs are likely to be much lower when applying the tax to goods and services sold by operations already collecting the sales tax on other goods and services they provide.

Following these guidelines, *Table 9.1* provides a summary of estimated revenue obtained from taxing additional personal services, non-commercial automotive repair and services, residential and consumer repair services, and amusements and recreational services at the general sales tax rate of 6%. A more detailed description of these services is found in *Table A.9.1* in the *Appendix*.

While the estimates found in *Table 9.1* suggest a significant increase in revenue arising from taxation of these services, we wish to emphasize that these are only estimates and may, in fact, be too high or too low. However, they should serve to give an indication of the potential magnitude of revenue obtainable from taxing these services. Of course, broadening the tax base also provides the opportunity to reduce tax rates if desired. The $176 million represents about 6% of the current 2.9 billion on sales tax revenue collected in Kentucky.

Table 9.1: Services Considered for Taxation and Estimated Revenue, by Category ($2012 Millions)

Category	**Tax Revenue ($Million)**
Personal Services	$ 70.12
Non-Commercial Automotive Repair and Services	$ 65.85
Other Residential and Consumer Repair Services	$ 5.45
Amusements and Recreational Services	$ 34.99
Total	**$ 176.41**

Source: Authors' calculations based on Governor's Office for Economic Analysis and 2007 Economic Census, Census Bureau, Department of Commerce.

Sales Tax Option 2: Impose a state gross receipts tax of up to 3 percent on providers of electricity for residential use

Residential electricity is exempt from the state sales tax in many states including Kentucky though Kentucky allows the imposition of a utility tax of 3% by local school districts. Imposition of a 3% state gross receipts tax combined with the 3% tax imposed by the vast majority of school districts would make an effective 6% rate, the same as the state sales tax rate. The state tax would presumably be a gross receipts tax (at least in part because the SSTP does not permit multiple tax rates) though it would have the same economic effect as a sales tax. Approximately 16 states tax residential electricity (including Illinois and Indiana), though in some cases under a special utility tax.[62] Residential electricity meets the criteria identified above for services that should be taxed. The tax could be legislated in ways that do not create substantial concerns about vertical equity, and specifically taxation of lower income households. Electricity consumption is likely correlated with income so the burden should rise with income. Also, a small adjustment could be made in the income tax to offset any additional sales tax burden on lower income individuals (such as a

[62] See Federation of Tax Administrators at http://www.taxadmin.org/fta/pub/services/services.html .

refundable credit for the tax implicit in electricity purchases by low income households), if there are further concerns about vertical equity.

The estimated increase in revenues from imposing a state gross receipts tax of up to 3 percent on residential users of is $360 million.

Sales Tax Option 3: Impose the sales tax on food for consumption at home and provide a tax credit or other means for to offset the additional tax burden for low-income households

The intent of this option is to indicate clearly that consumer goods should be taxed broadly, and mechanisms other than exempting wide categories of goods should be used to achieve vertical equity and other goals. Thirty states exempt food for consumption at home and other states, including North Carolina and Tennessee, tax food at a preferred rate. Food is representative of ongoing efforts in states to exempt consumer goods for a range of different reasons. Tax holidays and clothing are other exemptions that appear to be growing across the states. We believe that Kentucky's economy will work best if a broad set of goods is taxable at low rates.

Vertical equity, and particularly unfairness for lower income consumers is the traditional argument for exempting food. The purchase of food is regressive in consumption, but so are most other purchases (private education is an exception). So, the sales tax remains regressive even if food is exempt. Further, food stamps are exempt in all states, reducing some of the regressivity of taxing food.

Some have argued that the vertical equity goals could be achieved if food is kept in the base but lower income people are provided a smart card with an amount equal to the annual tax on food or if a credit is provided against the income tax. Alternative options to counteract the additional regressivity imposed by a tax on food include the use of an Earned Income Tax Credit *(EITC),* significant expansion of the standard deduction in the individual income tax code, or increases in the Family Size Tax Credit.

Based on the Governor's Office of Economic Analysis estimate tax expenditure associate with omitted food purchases, a tax on all food for consumption at home would increase tax revenue by $484 million in 2012, or the sales tax rate could be lowered significantly.[63]

9.2.1 Taxation of Business Inputs

Economists almost uniformly oppose taxes on business-to-business transactions and argue on conceptual grounds that all business inputs should be exempt. Current taxation of business inputs occurs for two reasons.[64] Political advantages may result because taxing business inputs allows the sales tax rate to be lower and hides much of the sales tax burden in product prices.

Also, a blanket exemption for all business purchases could lead to widespread evasion as people form businesses (or use existing businesses) so they can purchase items without paying the sales tax.

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[63]From "Tax Expenditure Analysis," Governor's Office for Economic Analysis, Office of State Budget Director, Commonwealth of Kentucky (November 2012).

[64] Also, business input purchases should be taxable in cases where the final sales to consumers are exempt. Tax on the inputs is intended as an indirect, though limited, means of taxing the final output. This explanation particularly fits inputs used in the production of non-taxable services.

This argument suggests that states probably cannot exempt all business purchases, and must carefully select the set of exemptions. Still, a strong case can be made to lessen taxation of business inputs. One reason is that the sales tax is intended as a tax on consumption, but businesses do not consume, they produce.[65] It is reasonable to presume that everything businesses purchase is necessary to produce and sell their product (regardless of whether the firm is a manufacturer, wholesaler, or retailer) and does not fit within the conceptual framework of a tax on consumption.

The other reason to exempt business purchases is that taxes on business inputs have the potential to alter business behavior and to harm the state's economy. First, taxing business-to-business transactions can change the way that businesses operate as firms seek to limit the amount of tax they pay.[66] Firms can substitute non-taxable inputs for taxable ones, to the extent that taxability differs and input substitution is possible. Alternatively, firms can vertically integrate and bring more production within a single company. For example, a firm can hire its own accountants and lawyers to avoid a tax on hiring the service from outside. Firms should be less profitable to the extent that taxes alter the way that business is done, since firms would bring the lawyers and accountants into the firm without the tax, if this were generally the lowest cost way to operate.[67] No evidence exists on the extent to which firms vertically integrate to lessen their tax burdens, but the largest responses would be expected from big firms, which are in the best position to vertically integrate. Not only are smaller businesses less able to vertically integrate but also they are probably less profitable as larger companies outsource less in response to taxation on transactions between firms.

Second, input taxes raise the cost of producing in Kentucky, which can cause some firms to locate their production in states that impose lower tax burdens on business transactions. No empirical research directly examines the extent to which taxes on business inputs harm a state's economy, though some research considers whether higher sales taxes (measured by the tax rate) generally harm a state's economy. For example, Bruce, Deskins, and Fox (2007) find that Gross State Product falls as states increase their sales tax rates. They argue that the effects of taxes on location are growing because technology makes it increasingly easy for firms to geographically separate their production from their markets.

No research directly examines the issue of whether firms move their production activity in response to decisions by states to broaden or narrow their tax bases to include various business-to-business transactions or to tax these transactions at higher rates. Still, it is reasonable to presume that bigger taxes on business purchases reduce the propensity for firms to locate or produce in a state. Further, these effects are likely largest for those firms purchasing the greatest amount of taxable inputs and those firms that can most easily separate their point of production and their markets (such as many firms producing for national or international markets). Thus, the effects are likely to vary across industries and sizes of firms.

Third, taxation of business purchases cascades into higher taxes on the final product. The extent of cascading depends on the complexity of the production process (how many levels of production a good or service goes through), the tax treatment of the various business transactions, and the propensity to vertically integrate in the industry. As a result, the amount of cascading can vary

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[65] This statement ignores any propensity to use a company to make purchases of goods that are intended for personal consumption. This can be a form of tax evasion that is intended to lower sales and income tax liabilities, and does not represent the firm operating as a business and producing.

[66] The gross receipts tax discussed above can create the same distortions, but the effects are likely to be small if the rate is kept under 1.0 percent versus the 6.0 percent for the sales tax.

[67] Of course, vertical integration is the best business model for some activities in some firms even without the encouragement from taxes.

significantly across economic sectors. Assuming that business purchases of capital equipment, communications equipment, utilities, and office supplies are taxable, Hawkins (2002) finds that the sales tax is imposed on inputs equal to 14.7 percent of the revenues of electric producers, 11.2 percent for firms taking fees and admissions, and 11.5 percent for firms providing non-shelter lodging. The cascading can have important economic effects as it raises the relative price of some goods and causes people to purchase less of these goods. Hawkins finds that the loss in wellbeing in a state as a result of differential effective tax rates because of cascading is small in states with broad based taxes, and the losses are much larger if states adopt narrow tax bases.[68] This conclusion follows because the sales tax distortions, other than from cascading, are smaller for states with broad based sales taxes. While the Hawkins' cascading estimates are for an average state and do not necessarily fit Kentucky, the results suggest the problems from cascading may be greater in Kentucky because of the narrow sales tax base.

Russo (2005) finds that eliminating the tax on business inputs results in a small increase in the size of the state's economy and an improvement in a state's wellbeing, even though the tax rate must be higher.

Sales Tax Option 4: Exempt business purchases of energy

Business purchases of energy should be relatively easy to exempt without allowing consumers to take advantage of the exemption. The exception is people who live and work in their home. The biggest problems of taxing energy are lessened because energy is exempt for the most intensive users, but the advantages described above would still result.

It is estimated by the Department of Revenue that exempting business purchases of energy would reduce revenue collections by $124 million annually.

Sales Tax Option 5: Impose a gross receipts tax of between 1 and 3 percent on both residential and business electricity.

Sales tax option 5 merges options 2 and 4 into an intermediate step. The revenue impact of this option depends on the tax rate chosen.

9.2.2 Remote Purchases

Kentucky cannot require many e-commerce firms to collect and remit the sales tax because the firms do not have nexus, or taxable presence, in the state.[69] Bruce, Fox, and Luna (2009) estimate that Kentucky lost – million in 2012 because of inability to collect tax on remote sales. Kentucky's use tax legislation requires buyers to remit the sales tax on their own if the vendor did not remit the tax, but voluntary compliance by individuals is generally believed to be very limited. Voluntary compliance by business purchasers is much better than for individuals, though businesses appear to have much lower compliance with the use tax than with the sales tax.[70] In the longer term, sales tax compliance can be enhanced significantly if remote vendors are required to collect and remit use

[68] Effects on a state's wellbeing are measured by changes in the excess burden of the tax.

[69] The U.S. Supreme Court in *Quill, Inc. v. North Dakota* ruled that a state can only require firms with physical presence in the state to collect the sales tax.

[70] For example, in an audit of registered taxpayers Washington State (2010) found 24 percent non-compliance with the use tax but only 1.7 percent noncompliance with the sales tax.

taxes either because Congress enacts legislation that creates nexus for remote vendors or because the Supreme Court overturns the Quill Case that established sales tax nexus on a physical presence basis. Tax administrators and analysts generally conclude that mandatory collection by vendors significantly improves revenue performance relative to voluntary collection by either buyers or vendors, so the revenue potential is dramatically enhanced by mandatory compliance.

Sales Tax Option 6: Support federal legislation allowing states to require remote firms to collect the sales tax.

States have limited ability to require remote firms to collect the sales tax and Kentucky has taken some important steps including joining the Streamlined Sales Tax and placing a line on the income tax for people to file their use tax returns. But, Congress controls the ability for states to require firms to collect the tax (because the Quill case was decided on an interstate commerce basis, which Congress controls). Three bills to require remote vendors to collect state sales taxes were introduced in the U.S. Congress during 2011: the Main Street Fairness Act,[71] the Marketplace Fairness Act,[72] and the Marketplace Equity Act of 2011.[73] All of the bills allow states that simplify and harmonize their sales taxes to require certain remote vendors to collect their sales tax. Differences between the bills arise mainly in the simplification and harmonization criteria and the small seller exception that determines the sales that a firm must make before it can be required to collect the tax. Much of the current discussion of the legislation focuses on the appropriate small seller exception, and the amount listed in any bill is readily subject to change. But, it is nearly certain that such an exception will be allowed whenever the legislation passes Congress.

Pending review of final legislation, the Department of Revenue estimates and additional $120 million in revenue from taxation of remote firms.

9.3 Business Tax Policy Options

Goals for corporate/business tax reform could include:

- **Broaden the set of taxpayers.** The corporate income tax is only levied on corporations, so corporations, whether producing in Kentucky or not, bear higher tax burdens for selling in the state than do other business structures. [74] Similarly, the LLET is only levied on limited liability companies. The taxes could be extended to cover all businesses.

- **Seek to bring taxation of services more in line with the taxation of goods.** A corporate income tax is more likely to be paid by traditional manufacturing than by service firms.

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[71] S. 1452, 112th Cong., 1st Sess. (2011); H.R. 2701, 112th Cong., 1st Sess. (2011).
[72] S. 1832, 112th Cong., 1st Sess. (2011).
[73] H.R. 3179, 112th Cong., 1st Sess. (2011).
[74] The set of taxpayers is even narrower because Kentucky is limited in its ability to tax certain corporations, such as those whose only relationship with the state is to solicit for the sale of tangible personal property. This is based on federal legislation, usually referred to as PL 86-272, which prevents states from imposing a corporate income tax on firms whose only relationship with a state is to solicit for the sale of tangible personal property.

- **Reduce the extent of tax planning.** Businesses often seek to plan their tax liability by designing their corporate structure to exploit differences in state tax systems. Tax liabilities will be lowest for those firms that are best able to exploit the overall system. At a minimum, corporations that operate solely within Kentucky will pay higher tax burdens than firms better able to tax plan.

- **Stimulate Kentucky's economy.** Everything else equal, lower corporate taxes will enhance the state's economy. Of course, the net effect of higher taxes combined with spending that makes business more productive could be positive for the economy.

Tax options are raised in light of these goals and the remainder of this section discusses three groups of options: reform of the existing taxes, major change in the business tax structure, and property tax changes.

<u>Reform the existing corporate and LLET tax structures:</u>

Business Tax Option 1: Conform the corporate income tax base with Federal Code as of a specific date

Compliance and administration costs are lessened when the U.S. government and state governments use the same bases for their taxes. But, federal definitions are often changed using short term goals without consideration of implications for state government tax revenues and in some cases using poor policy. Conforming with federal legislation as of a specific date minimizes compliance and administration costs while permitting Kentucky to determine whether to conform to future federal policy changes.

The precise impact of this option depends on federal code at the date of conformity. Based on current code, the revenue impact is estimated to be -$16 million with this amount decreasing over time.

Business Tax Option 2: Addback management fees in calculation of the corporate income tax base

States use one of several means to reduce the extent of tax planning including:

- Enact addback rules
- Enact combined reporting
- Assert economic nexus over passive investment companies
- Audit passive investment companies for business purpose
- Extend corporate income taxes to LLCs or all business structures.

Kentucky has chosen to use addbacks, as evidenced by the inclusion of trademark payments in calculation of the corporate income tax structure. Addback statutes apply to specifically identified intercompany expenses, such as royalties, interest, and management fees. When addbacks are required, the intercompany expense is effectively disallowed for corporate income tax purposes. Addback statutes may result in more accurate measurement of income attributable to a state if the intercompany payments do not reflect real costs. Also, addback statutes will often bring a taxpayer's attention to an expenditure item, requiring the taxpayer to self assess whether the amount is

reasonable and traceable. Twelve states have addback requirements that include royalties, intangible-related interest, intercompany interest, and management fees and another 13 states have narrower addback requirements such as in Kentucky. This option expands Kentucky's addback statute to include management fees. Addback requirements always increase tax revenue because by definition they either have no effect or raise a company's corporate income tax base. The option is expected to raise about $13 million.

Business Tax Option 3: Use Destination Sourcing for Services

Services are sitused where they are produced rather than where they are used. As a result, greater weight on the sales factor does not have the same effect on services. Kentucky corporate tax liabilities rise as more services are produced in the state (regardless of whether the services are sold in or out of the state) and the tax does not increase for firms that produce services out-of-state for sale in the state. Thus, greater weight on the sales factor discourages production of services in Kentucky.

Eleven states, including several from the competitor group, have recognized that situsing of services on an origination basis is inconsistent with their efforts to stimulate the economy and have amended their statutes to tax services where they are enjoyed rather than where they are produced. Table 1 lists these states and when they adopted destination situsing.

Table 9.2: States Destination Situsing the Services Factor

State	Year adopted destination situsing
California	2011
Georgia	2002
Illinois	2009
Iowa	2002
Maine	2007
Maryland	2006
Michigan	2008
Minnesota	Many years
Ohio*	2003
Utah	2009
Wisconsin	2005

*Replaced corporate income tax with a gross receipts tax.

Four arguments can be made for using destination situsing for services. First, destination sourcing of services is consistent with the way Kentucky sources goods so this would allow even taxation between goods and services. Economists argue for even taxation, which is often termed neutral taxation, because neither the goods nor the service producing sector is tax advantaged relative to the other. Further, consistency in the treatment between goods and services would remove possible ambiguity in the statutes since it is not always clear whether companies are selling goods or services.

Second, as described in the section on single factor sales apportionment, origin taxation of services raises the costs of producing in Kentucky since the tax is imposed whenever production occurs in the state. The cost imposed by the tax discourages firms from producing services in Kentucky for sale to residents of other states (or at least encourages firms to locate any expansions in their service production outside the state) because tax is imposed on the production. But, the structure is even more perverse because it discourages production in Kentucky for sale to Kentucky businesses and people. No tax is imposed on firms that sell services to Kentucky residents that are produced in other states but the tax is imposed if the same service is sold by a Kentucky firm to in-state residents. Thus, the incentive is to produce services outside the state.

Third, under origin sourcing, firms that produce services in the state and sell services outside the state can be taxed twice on the activity. Differences in state tax structures can result in businesses paying tax in more than one state on the same profit. Specifically, Kentucky firms can pay tax to the state and pay taxes again if the services are sold to destination situsing states such as Georgia and Illinois.

Fourth, destination sourcing of services is consistent with other recent changes in corporate taxation. Most states, including Kentucky, have moved to place more weight on the sales factor as a way to reduce the taxation of production in their state. Origin sourcing of services is inconsistent with the objective of reducing the taxation of instate production by raising the weight on the sales factor.

The revenue implications of destination situsing cannot be measured based on any information filed on existing tax returns because firms report on an origin basis. Indeed, firms probably cannot indicate how they would file if Kentucky changed the situsing statutes because firms may alter where they produce services and how they file. Empirical analysis of how revenues have been affected by adoption of destination sourcing in other states suggests that the net effect on tax revenues is probably very small, with the odds of a small decrease being about the same as a small increase.

Business Tax Option 4: Replace the double-weighted sales formula with single factor sales apportionment for the Corporate Income Tax

Multi-state firms are required to apportion their corporate income tax between states. All states use a variation on a three-factor formula that apportions based on the location of payroll, property and sales. Essentially all states placed equal weight on the three factors several decades ago. Further, states have traditionally sitused sales of goods to where the market is located (on a destination basis). As a result, there has been a strong tendency to increase the weight on sales in the formula, which moves the tax towards a sales tax at a rate that depends on the profitability of the corporation. Kentucky double weights sales (puts 50 percent weight on the sales factor) in the formula. At least 12 states now use single factor apportionment based on sales and another four or more states have greater weight than Kentucky, but do not have single factor apportionment.[75] Movement to single factor sales weighting of the corporate income tax has been justified as a way to reduce taxation of production because the tax becomes linked to the amount of sales in a state and not the amount of employment, investment or production. Changes in the apportionment formula weightings have no implications for a firm that produces and sells its entire product in Kentucky.

[75] http://www.taxadmin.org/fta/rate/apport.pdf

The effects of increasing the weight on sales and decreasing them on employment and production in a state depend on the net of several factors. Greater emphasis on the sales factor raises the tax on purchases by instate buyers (some of whom are businesses producing in the state) which presumably discourages buying (or at least raises the costs for corporations to sell) in the state by both businesses and consumers. On the other hand, lower weights on property and payroll reduce the costs of hiring workers and using physical capital in the state. The net effect is an empirical question. Research generally finds that state economies are stimulated by greater emphasis on the sales factor (moving towards a destination tax), but the effects on individual states depend on specific characteristics of the region where the state is located.

Assuming no change in purchasing patterns, increasing the weight on the sales factor means more tax revenues will be remitted by firms that produce relatively less in a state than they sell and the reverse for firms that produce more than they sell. The effect on aggregate revenue depends on the net effect of the two groups of firms plus any influence on firm and consumer behavior as the tax structure is altered. The overall research has somewhat mixed results with some suggesting more revenues and some less revenues. Estimates for Kentucky from the Department of Revenue place an annual loss of $64 million in revenue.

Business Tax Option 5: Lower the $3.0 million LLET threshold to $1.0 million and phase out the effects through $2.0 million

Kentucky made a number of changes in its corporate tax structure in 2005 and 2006. Like most states, Kentucky did not revise its tax statutes when it legislated the LLC, in 1994, as a possible organizational structure and later imposed the corporate income tax on LLCs. Kentucky also enacted a minimum tax as a percent of gross receipts as part of the corporate income tax structure. Subsequently, the limited liability entity tax (LLET), which is levied on all firms with limited liability including C-corporations, was enacted and LLCs were exempted from the corporate income tax. The LLET imposes the minimum of 0.75 percent on profits or .095 percent of gross receipts. Companies paying the corporate income tax are permitted a non-refundable credit against the LLET for corporate income taxes that are paid. The LLET limits the extent of tax planning for C-corporations and imposes a small tax on LLCs. Kentucky could move back to a single tax by building the minimum gross receipts tax into the corporate income tax structure and imposing the corporate income tax on LLCs. This improves the tax structure since LLCs and LLPs are often used inside of corporate umbrellas for tax planning purposes. The LLET collects some tax from LLCs and unprofitable corporations, but still gives companies an incentive to tax plan using LLCs inside the corporate structure. A much more restricted alternative is to lower the threshold that determines the minimum amount paid under the LLET to $1.0 million (or less) and phase out the benefits of the exemption until $2.0 million in revenues.

The revenue threshold in the LLET is relatively large. A minimum $175 tax is levied on limited liability entities with $3.0 million or less in revenues and the benefits are phased out through revenues of $6.0 million. A decision on the appropriate threshold should be made after considering effects on administration and compliance, revenues, and economic efficiency. Taxing all transactions in a similar fashion lessens distortions in business practices and consumer purchases and imposing special rules such as thresholds is likely to create unintended consequences. The $3.0 million threshold places a kink in the tax system where essentially no compliance is necessary below the legislated amount and full compliance is necessary above the amount. Behavioral changes can be

expected when certain taxpayers are omitted from the tax and the potential for distortions rises with the size of the threshold. For example, companies could seek to avoid the tax by splitting into multiple businesses, each operating just below the threshold. Vendors in certain industries, and particularly ones characterized by low productivity, will be most likely to operate below the threshold. LLET revenues are surely reduced significantly by the threshold. A larger threshold reduces the number of firms required to comply with the LLET, which essentially eliminates compliance costs for the firms and reduces the number of taxpayers that Kentucky must control.[76] It is important to remember that the administrative costs for firms below the threshold are not eliminated since Kentucky still must do some audit of whether firms meet the minimum threshold for compliance and the possibility exists that firms will intermittently comply as they exceed the threshold some years and not others.

The $3.0 million threshold means that 82 percent limited liability entities pay the minimum $175 tax. Certainly, some of the reason is that the kink in taxes at $3.0 million provides firms with an incentive to stay small or to divide into small firms. Some examples exist from practice around the world. Ohio established a $1.0 million threshold for the CAT and a strong case can be made that this is too high. No country in the European Union allows a threshold above approximately $140,000.

The Department of Revenue estimates a gain in $14.2 million in revenue from this option.

Major reforms:

Business Tax Option 6: Replace the Corporate Income Tax and LLET with a Gross Receipts tax or some other sources of revenue.

Michigan, Ohio, Oklahoma, and Texas, recently imposed differing versions of a gross receipts tax (GRT) on all businesses, including corporations and unincorporated businesses.[77] A number of other states, including Washington and Delaware, have imposed such taxes for many years. Kentucky could impose a similar tax, and already does to some extent with the gross receipts alternative base under the LLET. The GRT would differ from a sales tax in that no exemptions would be allowed but also in that the rate would be very low (Ohio's rate is 0.26 percent). Implications of the GRT for Kentucky's economic activity can be limited by imposing the tax only on transactions that have their destination rather than their origin in Kentucky. Thus, no tax would be imposed on sales by Kentucky firms to businesses and residents outside the state. Tax would be imposed on all sales to buyers in the Commonwealth, whether the purchaser is a consumer, business or government. Additional cost would be imposed on firms operating in Kentucky if they buy inputs (on which the tax would also be levied). The component imposed on inputs would be implicit in the costs of operation in Kentucky whether the firm sells to Kentucky or out-of-state buyers.

A GRT can expand the set of business taxpayers by including unincorporated businesses and firms protected from corporate income taxes by the PL 86-272 constraint. PL 86-272 is a limitation on income based taxes, so it may not apply to a gross receipts tax, depending on how the courts ultimately rule on this issue. GRTs are also a means to expand the taxation of the service economy relative to the goods economy since service firms are less likely to be incorporated (which means

[76]Firms will need to keep accurate bookkeeping and accounting records for business purposes, but these should not be viewed as compliance costs.

[77] Michigan subsequently eliminated its gross receipts tax.

they are not paying the corporate income tax) and their sales are less likely to be taxable through the sales tax. Further GRTs are a means to limit tax planning, since managing the corporate profits that are reported for tax purposes is a common form of planning and it is more difficult to tax plan around gross receipts taxes.

Economists generally object to gross receipts taxes because the extent to which the tax is built into prices (i.e., the tax cascades) depends on the number of steps that items pass through in the production process. Cascading distorts relative prices compared with a uniform tax on all consumption and should cause consumers to buy relatively less goods and services where the greatest cascading occurs.[78] A related problem is that firms may choose to vertically integrate to avoid the tax, which reduces efficiency if firms are only integrating to avoid the tax. A low tax rate should lessen the concerns about vertical integration and distortion of behavior. A State of Washington study measured the degree of cascading from a GRT (defined as the effective tax rate on an industry divided by the actual tax rate) for a range of different industries.[79] On average the effective rate was 2.5 times the stated tax rate,[80] but the degree of cascading varied from 6.7 times for industries such as food manufacturing and petroleum refining to 1.4 times for data processing.

Individual businesses may object to a GRT either because they do not understand it or because their tax liability rises. Assuming revenue neutral imposition of the tax, unincorporated, unprofitable, and service firms will generally see a tax increase and incorporated, profitable, and heavier industries will see a decrease. Firms with very low markups (such as grocery stores) will be particularly likely to object because they will view the tax liability as large relative to their gross margin.

A GRT would entail lower administration and compliance costs than the existing taxes, since firms would only need to calculate sales in Kentucky and would not need to calculate profits. For corporations, the tax base can be thought of as the numerator for the sales factor in the corporate income tax formula, which is simpler to calculate. The Ohio tax return is essentially a postcard because it only requires gross receipts, an exclusion, and calculation of tax liability. On the other hand, movement to a new tax structure entails a series of transition concerns. Issues will need to be decided such as, how are accrued credits to be treated, will firms be able to carry losses developed prior to the tax forward, how will previously promised tax incentives be handled and so forth.

Calculating the revenue neutral GRT rate is complicated because it requires estimating the total number and value of transactions in the Kentucky economy and making assumptions about the extent to which deductions or exemptions would be allowed. Ohio adopted a very broad based tax with very few exemptions; though the Ohio statute allows a $1 million exclusion from the base (a $150 minimum tax is imposed). The Ohio experience provides a pattern for estimating the lowest possible rate that could be imposed in Kentucky (since the base is so broad). The Ohio Department of Taxation reports that total gross receipts reported on tax returns were $665.2 billion in 2008 and taxable gross receipts after the exclusion were $579.5 billion, which is 1.23 times the size of Ohio Gross Domestic Product. Then assuming that taxable gross receipts in Kentucky would be also be approximately 1.25 times its GDP of 164 billion, to raise the loss revenue from the Corporate Income Tax and LLET of $675 million, the tax rate would need to be .33%.

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[78] Of course, neither the sales tax nor the corporate income tax is uniform against all commodities either.

[79] Washington State Tax Structure Study, "Tax Alternatives for Washington State: A Report to the Legislature," Final Report, November 2002.

[80] Washington imposes 18 different tax rates, which may explain some of the cascading.

Alternatively, another option would be to entirely eliminate the corporate income and LLET taxes and replace with other sources of revenue, presumably taxes on consumption rather than business.

State corporate income taxes are justified on several grounds but none of them appear to hold up well to scrutiny. Corporate income taxes are generally intended to raise revenue, but the question remains why this tax is the best option for generating revenues. Two explanations are often given for choosing the corporate income tax relative to alternative revenue sources, such as personal income, sales or property taxes: to tax retained earnings or as a payment for the benefits from public services.[81] Several other arguments for corporate taxation are also mentioned occasionally, including because businesses are an easier point than individuals for collection of taxes and as a means of diversifying government tax instruments. The latter two probably are not good justification in Kentucky.

Corporate income taxes could be imposed to ensure taxation of retained earnings. In the absence of a tax on retained earnings, individuals have the incentive to house their assets and incomes in a corporate structure to avoid the individual income tax. The argument surely has some merit at the national level, but existence of the federal corporate income tax may be sufficient to limit the use of the corporate form to avoid the individual tax and should preclude the need for state corporate taxes for this purpose (particularly if Kentucky requires taxpayers to file in Kentucky in the same way as nationally). Further, a corporate income tax on retained earnings should be paid where the owners of capital (the shareholders) reside, but the corporate income tax is apportioned to the state where firms' physical assets or the market for their product is located. Thus, the corporate income tax accrues to the wrong state, and likely at the incorrect rate, to attain this objective.

The corporate income tax may be intended as a charge for the benefits that firms receive from public services. The public sector provides corporations with limited liability, which could be justification for a tax only on firms granted limited liability but this certainly argues for a tax on all firms with limited liability and not just C-corporations. Business taxes, such as the corporate income tax, have also been justified as a means of charging for the broader public service benefits available to businesses, such as access to the legal system and a trained labor force. A tax levied only on corporations is too narrow to serve as a charge for general public service benefits, because all firms, whether corporations or pass-through entities and whether profitable or not, benefit from public services. Thus, a benefits tax justification argues for a broad tax on business. But, businesses pay the range of other taxes, such as the sales, property, and unemployment insurance taxes, and pay approximately 40 percent of all taxes (see Ernst & Young, 2012). It seems unlikely that the public service benefits accruing to corporations are sufficient to justify an additional tax on corporations based on the benefits they receive.

The bottom line is that no strong justification for a corporate income tax appears to exist except that it raises money. But revenue from a corporate income tax comes at a very high cost in terms of economic distortions, such as effects on the relative use of capital versus labor and the location of

[81] An argument may also be made that capital is undertaxed relative to labor if state individual income taxes are levied on labor but state corporate income taxes are not imposed on capital (see Inman and Rubinfeld, 1997, for discussion of the tendency to undertax capital at the subnational level). But, the local property tax operates as a significant tax on capital and certainly overcomes at least some of the concerns about low state/local taxes on capital since the property tax generates more revenue than either the sales or personal income tax.

business. Overall, state corporate income taxes perform poorly as revenue instruments because they can cause significant economic distortions, are expensive to administer, and attract much more than their share of legislative attention. As a result, a compelling case can be made for eliminating the tax.

The CIT and LLET generate very little revenue in Kentucky and much of the tax is likely to be reflected in lower wages for Kentucky workers or higher product prices for Kentucky buyers. The Commonwealth could choose to tax people directly by replacing the corporate and LLET tax revenue with a broader sales tax base or by raising the personal income tax rate. Effectively, the argument is that it is more efficient to impose taxes directly on people than to impose taxes on corporations with the expectation that the tax will be passed forward to people in higher product prices or lower wages. The state's economy will be strengthened by not using business as an intermediary to tax people.[82] Further, Kentucky would receive the public relations benefit of saying that the state imposes no tax on corporations. As described above, the academic literature indicates that lower rates offer some economic benefits by attracting business activity, and a 0 rate would offer the greatest advantage.

Property Tax Options:
Options 7-9 focus on the property tax, and generally the property tax on business. However, option 9 also applies to residential property taxes.

Business Tax Option 7: Eliminate Personal Property Taxation

Options 7 and 8 deal with taxation of categories of tangible personal property. Personal property generally includes property other than real property. The first option is to exempt all personal property from taxation. Kentucky currently taxes machinery and equipment, motor vehicles, inventories, mobile homes and boats among others, at least under certain circumstances. Kentucky imposes the state but not the local tax in certain circumstances. An intermediate option is to exempt all personal property that is taxable only at the state level. Eleven states generally exempt tangible personal property, including Ohio which exempted tangible property in recent years.[83]

Exemptions for personal property are often considered either because of administrative problems or fear that taxation of equipment and inventories can create significant distortions. Difficulties in valuing many types of equipment are the main administrative concern. All taxes affect behavior, but a specific concern is that a tax levied directly on equipment and inventories will cause firms to be less productive as they employ less capital or to be less likely to locate in Kentucky. Implications of some taxes on personal property have been lessened by exempting the local share, but further steps could be taken. Mobile homes used for residential purposes should probably be included in the base since they are an alternative to residing in real property.

Business Tax Option 8: Exempt inventory from property taxation and eliminate the Barrel Tax

Inventories are included in the property tax base using declarations provided no later than May 15th. State but not local taxation applies to certain inventories in specific circumstances, such as motor

[82] Of course, the sales tax would also be more heavily imposed on domestic activity to the extent that Kentucky is unable to effectively collect sales tax on remote vendors and the sales tax is levied on business inputs.
[83] See http://www.lincolninst.edu/subcenters/significant-features-property-tax/Report_Taxable_Personal_Property.aspx

vehicles, farm equipment and boats that are held for sale. Only 13 other states currently tax inventories. Consideration should be given to exempting inventories. All taxes have the potential to alter behavior, but inventory taxes may be more likely to alter business practices than some other tax structures. The current taxation incentivizes firms to locate inventories outside Kentucky when the taxable value is being determined. The tax is also a disincentive to locate warehousing activity in the Commonwealth.

Consistent with the elimination of inventory from property taxation would be the elimination of Barrel tax. While the stored product subject to this tax may still be in the production process, the disincentives to store product in Kentucky are similar to those for the taxation of inventory. The estimated revenue loss from this option is $4.7 million.

Business Tax Option 9: Freeze the state property tax rate at 12 cents per $100 of value

H.B. 44 limits the growth in real property tax revenue to four percent annually, by reducing the tax rate accordingly whenever the property tax base grows faster than four percent. As a result the state property tax rate fell from 31.5 cents per $100 in 1979 to 12.2 cents, where it has remained for the past five years. Beginning in 2005, new property was excluded in calculating the base growth rate (new property was already excluded in application of H.B. 44 for local tax purposes). Exclusion of new property slows, but does not prevent the rate from falling. This option makes the state property tax more elastic by fixing the tax rate and allowing tax revenues to grow at the same rate as the total value of taxable property. The option also simplifies the state property tax since the rate is fixed. The option would slightly reduce revenues since it lowers the rate from 12.2 to 12 cents.

9.4 Local Revenue Options

While the primary focus of this report has been on state taxation, devising a coherent and effective tax policy for the Commonwealth requires joint consideration of both state and local taxes. State and local tax revenues are not independent – expansions or contractions of taxes by one level of government are likely to affect the revenues of the other level of government, a pheromone economists refer to as *vertical fiscal externalities*. A classic example is that of federal and state taxes on tobacco. Increases in the federal tax, by reducing the consumption of cigarettes, will reduce revenues from state cigarette taxes. An example for Kentucky might be related to the state individual income tax and occupational license taxation. If Kentucky increases individual income tax rates it might lead to relocation of households and firms employing them along our borders to our neighboring states. This would reduce revenues to the local governments losing employment as a result of the state's actions. Then, for this reason, and others it is important to give some thoughts to local revenues when consider state tax reform.

9.4.1 Concerns about and Issues regarding the Local Taxation in Kentucky

Section 7 provides a discussion of some of the more important concerns about local taxation in Kentucky. Here, before discussing options for reform, we briefly summarize them:

- **Revenue collection in Kentucky is extremely centralized.** Currently (2009), approximately 65% of state and local revenue in Kentucky is collected by the state government. Among our competitor states only West Virginia has more revenue collected by state government. There are

a couple of reasons that this may be a concern. First, if the state is feeling more constraints imposed on its ability to raise revenues, aid to local governments might decrease in an undesirable way. Current tax options for local governments leave them few choices. Second, significant transfers from the state to local government may result in the wrong economic signals being conveyed about the economic conditions and productivity of local areas in the state as well as reducing local fiscal discipline. Less reliance on state governments will require better alignment of local expenditures with local revenues.

- **Local Tax Sources in Kentucky significantly differ from Competitor States.** This, by itself, may not be a concern – the other states might have it wrong or have very different economic conditions. However, it does suggest a review of local revenues options might be in order. Of particular concern is the heavy use of local income taxes (the occupational license tax). Kentucky is one of only 15 states using local income taxes and local governments in Kentucky raise 25% of their revenue from this source compared to 4% for its competitor states. In contrast, approximately 12% of local revenue for our competitors comes from a general sales tax; Kentucky localities do not have the sales tax as an option. The use of local occupational license taxes in Kentucky along with our relatively high state individual income taxes makes for very high marginal tax rates on labor in a state with much of its economic activity on borders with states with much lower taxes on labor.

9.4.2 Options for Reforming Local Taxes

Here we propose only one option for local governments, the use of a local general sales tax. Below we outline some of the rationale for this option and discuss some issues regarded in its implementation.

Local Tax Option 1: A Local General Sales Tax

The ability of local governments to use a general sales tax will give them more flexibility and stability in their revenue collections. However, for a number of reasons the state must impose some limitations and constraints on the imposition of local sales taxes.

First, the local general sales tax must be collected by the state and it must be imposed on the same base. Independent collection would be costly and lead to significant problems with compliance. These criteria also follow the *Streamline Sales and use Tax Agreement* to which Kentucky is a full participating member.

Second, another concern is the pyramiding of tax collections by having different local governments within an area– for example, counties, municipalities, and school districts in the same area --- using different general sales tax rates. Collections by the state will significantly reduce the administrative concerns regarding multiple local entities but situsing the sales across local governments and multiple tax rate will increase the complexity for businesses and state tax collectors.

A third consideration is what locality receives the tax revenue. Tax revenue will be collected at the point of sale but as much as possible our recommendation is that receipt of tax revenue be *destination* not *source* based. Thus if a good is ordered in one municipality but shipped elsewhere the tax revenue should be credited to the municipality where the good is shipped and presumably

consumed. True destination taxation will only occur with goods that are shipped since the tax will be paid where possession of an item is taken if a person drives to a store in another county and takes possession in the other county.

The state will need to impose limits on the rates that local governments can set. As discussed earlier, a local sales tax will reduce state tax collections by decreasing sales in the state. This will be a particular concern for localities on state borders – high local sales taxes in these areas can be expected to reduce retail revenues and associated state tax revenues. Use of the sales tax by multiple types of local governments only compounds these concerns about the interdependent tax bases and the associated impacts on revenues.

As a result of a decrease in sales in Kentucky subject to the general sales tax as a result of the imposition of local sales taxes, state revenues are estimated by the Department of Revenue to decline by $10 million.

Finally, it should be mentioned that a local option sale tax (LOST) requires a constitutional amendment. The Supreme Court has held that under Ky. Const. § 181 the General Assembly cannot delegate the power to levy excise taxes such as sales and use taxes to subordinate units of government such as cities and counties I*C.C.C. Coal Co., Inc. v. Pike County*, 536 S.W.2d 467 (Ky. 1976)).

Table A.2.1: State Tax Revenue Totals (2011)

State	Per Capita		Revenue by Source (%)					
	$	Rank	Property	Sales	Select Sales	Individual Income	Corporate	Other
Kentucky	**2,335**	**2**	**5**	**28.4**	**19.6**	**33.5**	**5.1**	**8.4**
Alabama	1,798	9	3.7	25.2	27.8	32.4	3.5	7.5
Georgia	1,630	13	0.5	31.7	12.7	47.9	4.2	3.1
Illinois	2,287	5	0.2	25.2	21	38.1	6.3	9.1
Indiana	2,288	4	0	42.1	17.2	30.7	4.8	5.2
Mississippi	2,254	6	0.4	43.7	20.7	21.6	5.3	8.5
Missouri	1,682	11	0.3	29.4	16.4	44.9	3.2	5.9
North Carolina	2,320	3	--	27.6	16.7	44	4.9	6.7
Ohio	2,181	7	0	30.9	19.2	35	0.9	14
South Carolina	1,643	12	0.1	36.3	16.5	37.8	2.8	6.4
Tennessee	1,696	10	--	57	18.8	1.7	9.8	12.6
Virginia	2,150	8	0.2	19.9	13.7	54.7	4.6	6.8
West Virginia	2,772	1	0.1	23.5	23.5	32.4	6	14.5

Source: U.S. Bureau of the Census and Bureau of Economic Analysis. The Per Capita measure uses 2011 population estimated from the Census. The Percent of Personal Income measure uses 2010 state personal income from BEA. Selective sales taxes are state Excise taxes (i.e., motor fuel, alcoholic beverages, etc.).

Table A.2.2: State and Local Revenue Totals (2009)

	State and Local Own- Source Revenue				State and Local Tax Revenue						
	State Share		Per Capita		Revenue by Source (%)						
State	%	Rank	$	Rank	Per Capita	Property	Sales	Select Sales	Individual Income	Corporate	Other
Kentucky	**66.0**	**2**	**4905**	**10**	**3210**	**20.6**	**20.6**	**16.9**	**31.3**	**3.6**	**6.9**
Alabama	56.1	7	4926	9	2806	17.9	29	18.1	20.9	3.7	10.4
Georgia	46.0	13	4868	11	3275	33.1	28.5	8.6	24.8	2.2	2.8
Illinois	49.8	12	6019	1	4436	40.1	19	15.6	16.2	3	6
Indiana	56.5	5	5638	4	3696	30.3	26	11.7	23.9	3.5	4.6
Mississippi	59.4	3	4984	8	3042	26	33.6	13.5	16.5	3.6	6.7
Missouri	51.4	11	4839	12	3224	28.7	25	11.9	26.4	1.7	6.3
North Carolina	56.5	5	5121	7	3350	25.7	23.3	11.8	30.2	2.8	6.2
Ohio	53.8	9	5675	3	3812	29.8	20.4	11.5	28.7	1.4	8.2
South Carolina	55.0	8	5322	6	2851	33.8	23.9	10.8	21.5	1.9	8.1
Tennessee	52.3	10	4592	13	2836	26.3	46.4	11.6	1.2	4.6	9.9
Virginia	57.0	4	5971	2	3970	35.8	14	11.5	29.2	2	7.4
West Virginia	73.2	1	5421	5	3467	20.4	17.3	19.3	24.3	6.6	12.1

Source: U.S. Bureau of the Census. Own Source Revenues are all revenues collected by state & local government from its own sources (excluding federal transfers).

Figure A.3.1A: Public Welfare Spending as a Percent of Income, 2009

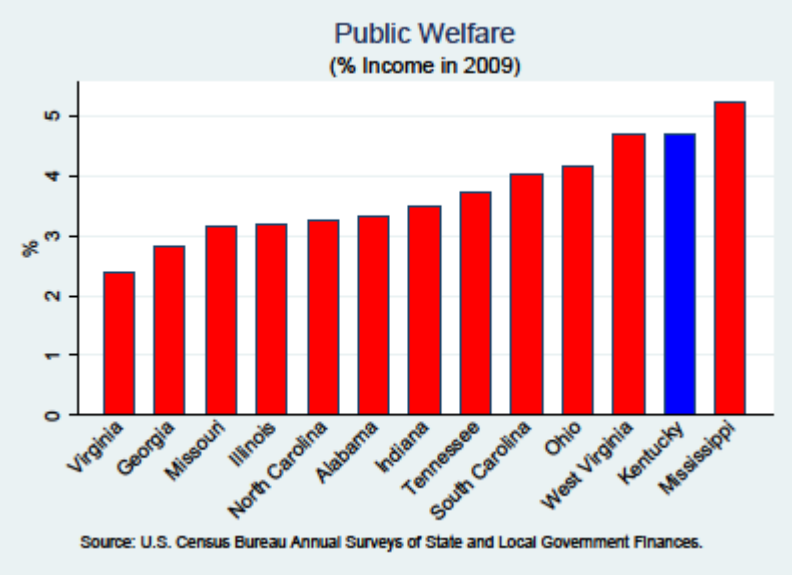


Figure A.3.1B: Public Welfare Spending per Capita, 2009

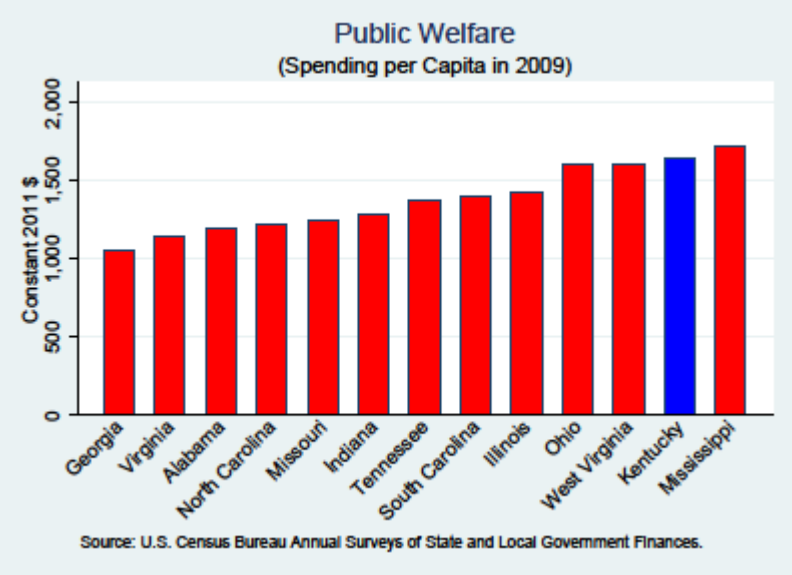


Figure A.3.1C: Public Welfare Growth in Spending, 2001-2009

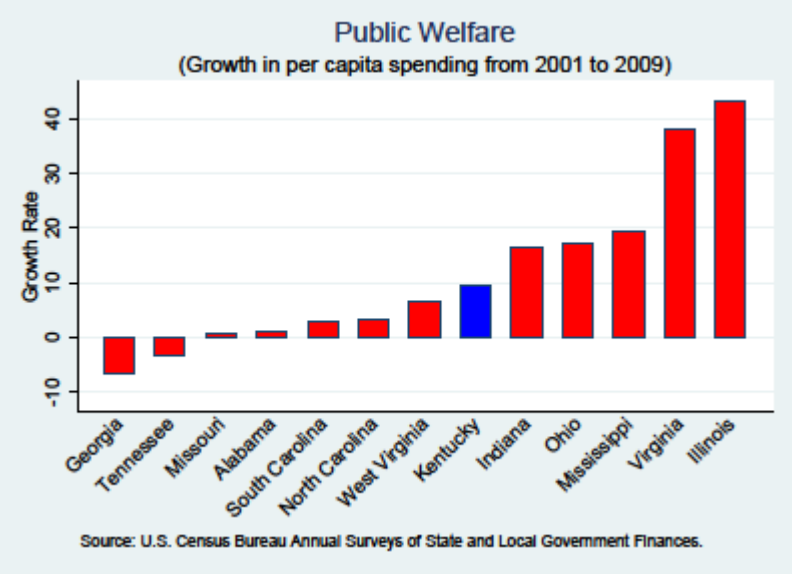


Figure A.3.2A: Elementary and Secondary Education Spending as a Percent of Income, 2009

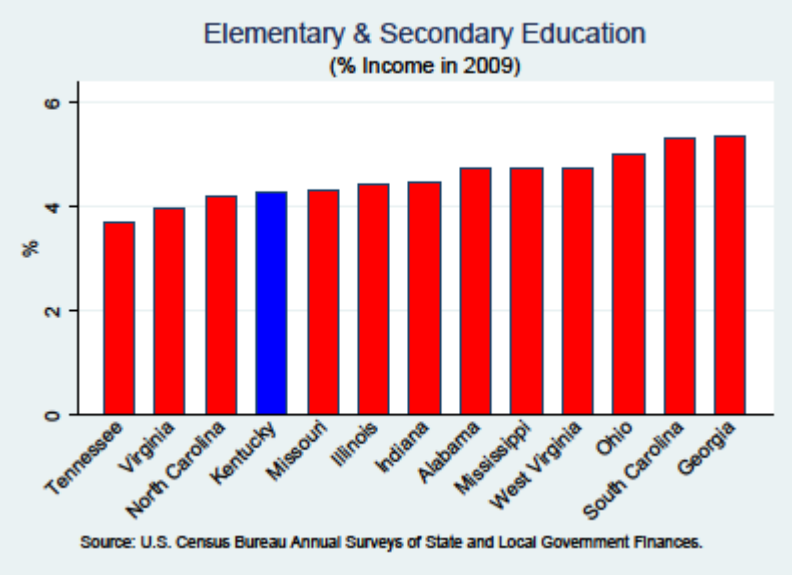


Figure A.3.2B: Elementary and Secondary Education Spending per Capita, 2009

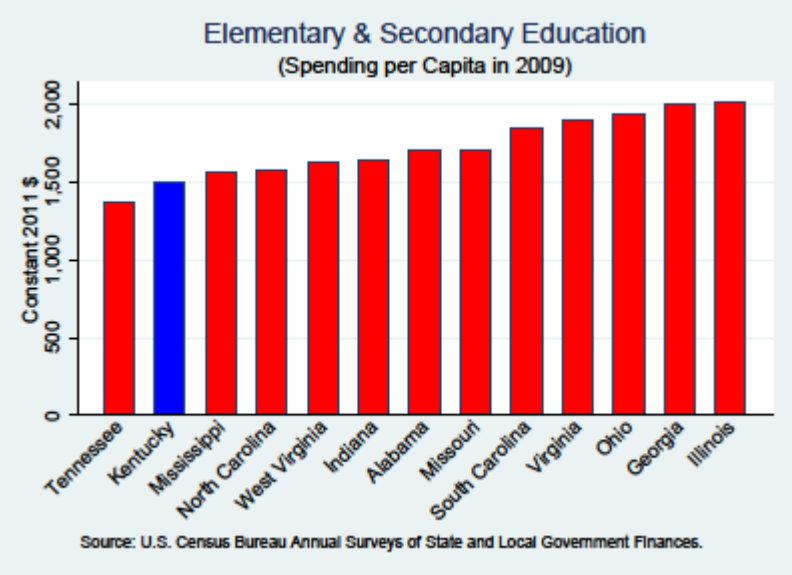


Figure A.3.2C: Elementary and Secondary Education Growth in Spending, 2001-2009

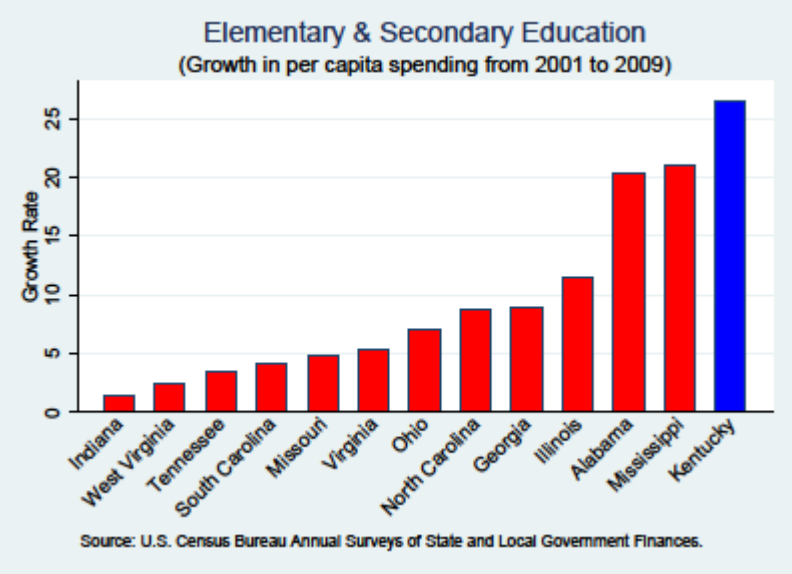


Figure A.3.3A: Higher Education as a Percent of Income, 2009

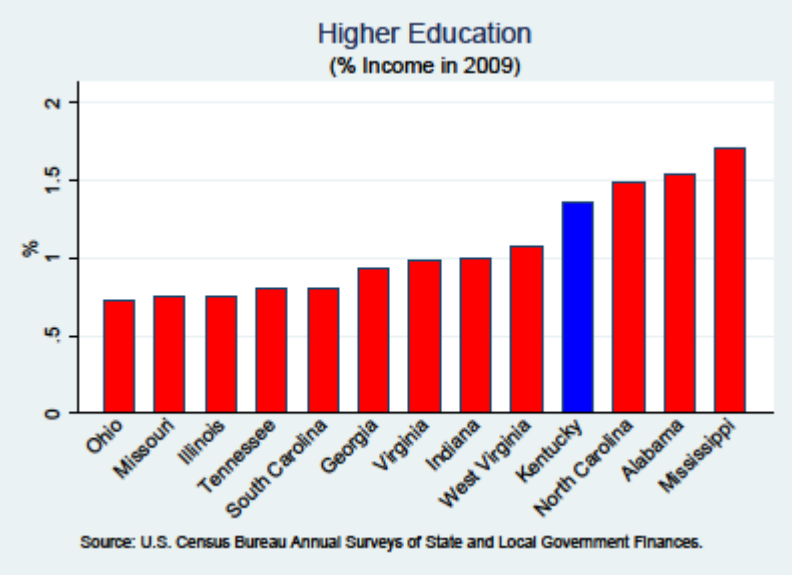


Figure A.3.3B: Higher Education Spending per Capita, 2009

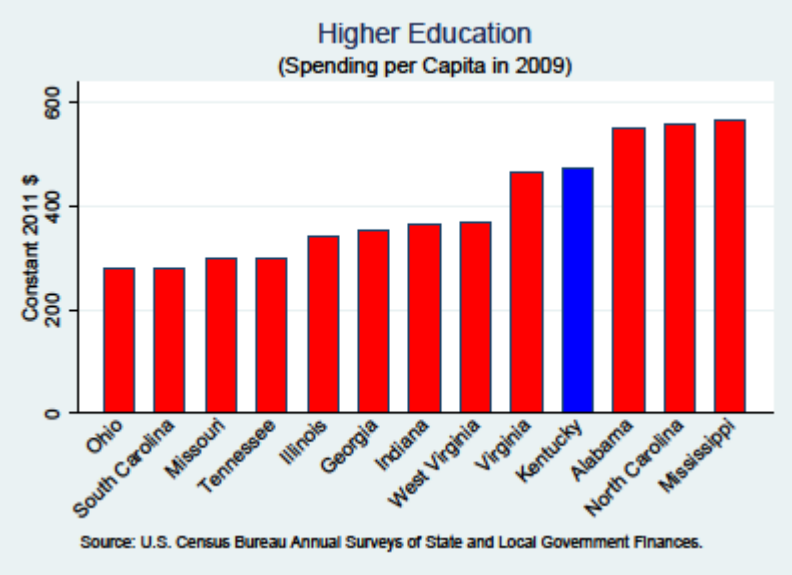


Figure A.3.3C: Higher Education Growth in Spending, 2001-2009

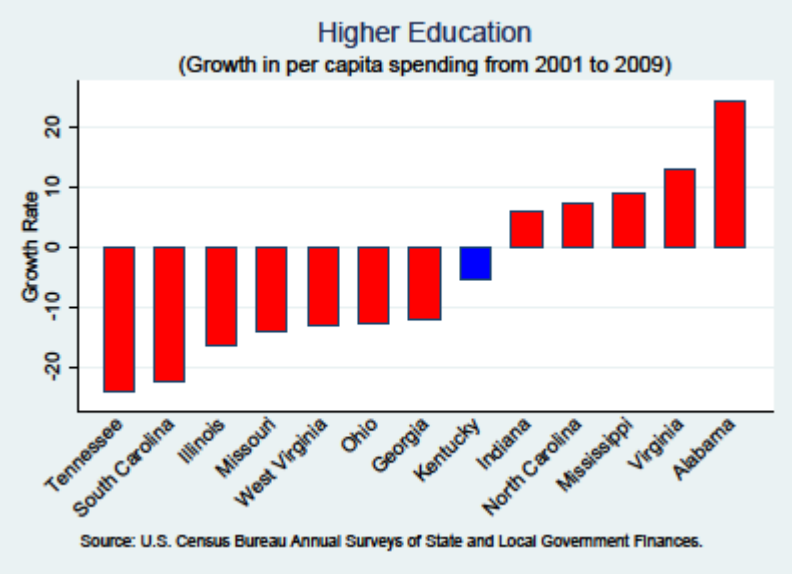


Figure A.3.4A: Transportation as a Percent of Income, 2009

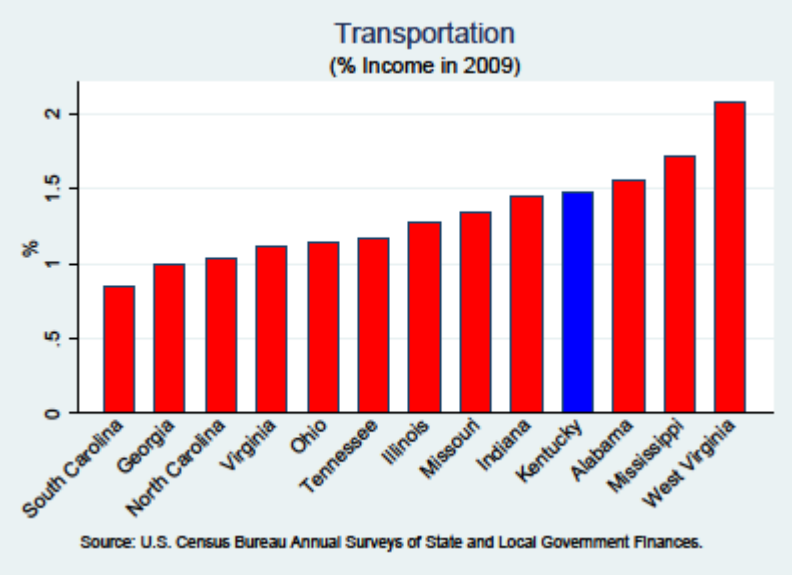


Figure A.3.4B: Transportation Spending per Capita, 2009

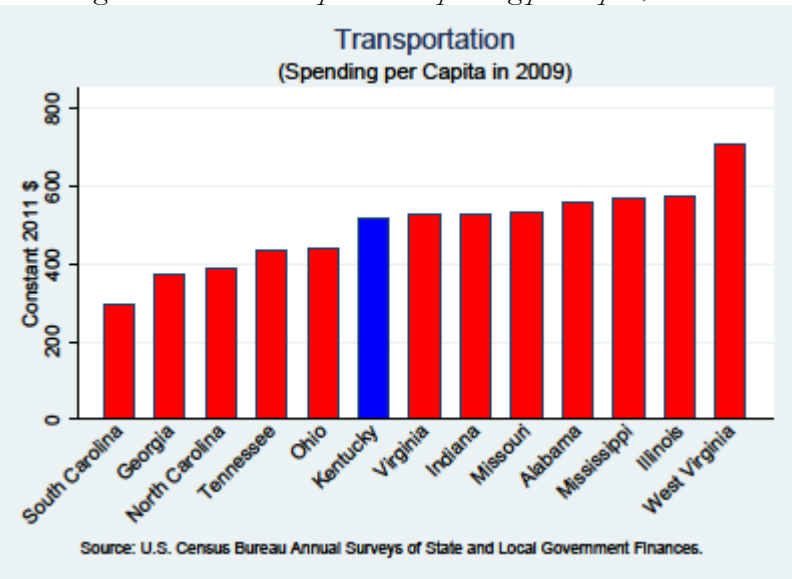


Figure A.3.4C: Transportation Growth in Spending, 2001-2009

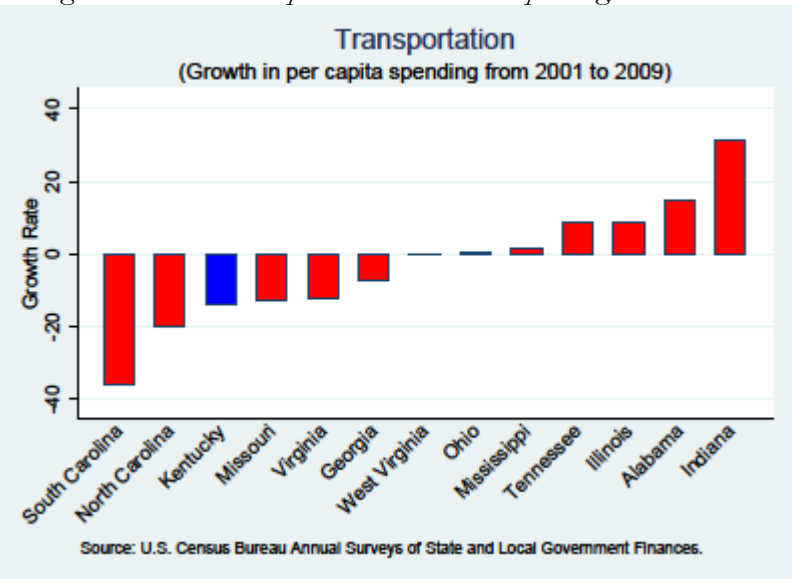


Figure A.3.5A: Corrections as a Percent of Income, 2009

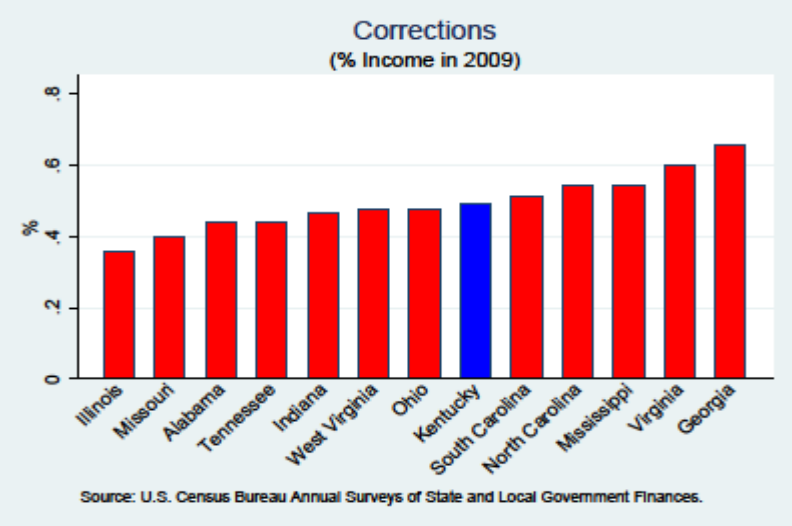


Figure A.3.5B: Corrections Spending per Capita, 2009

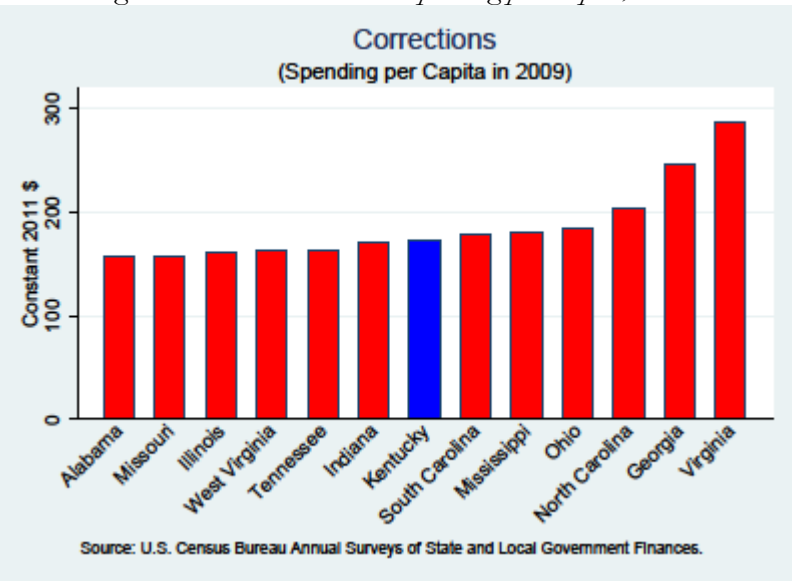


Figure A.3.5C: Corrections Growth in Spending, 2001-2009

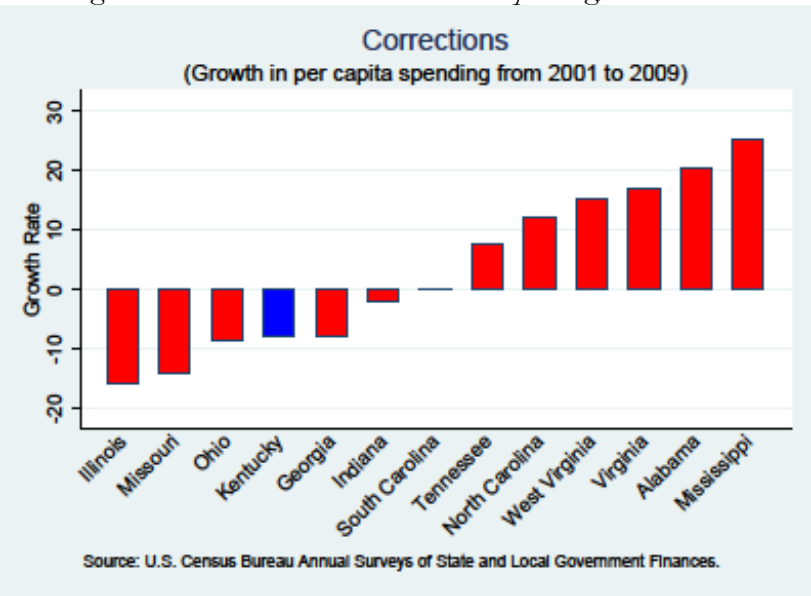


Table A.4.1: Estimated Direct General Sales Tax Burdens (2010)

Item	All consumer units	Less than $5	$5 to $9,999	$10 to $14,999	$15 to $19,999	$20 to $29,999	$30 to $39,999	$40 to $49,999	$50 to $69,999	$70 to $79,999	$80 to $99,999	$100 to $119,999	$120 to $149,999	$150 and more
Average annual expenditures.	$48,108	$20,747	$18,296	$19,909	$24,934	$29,158	$35,556	$40,616	$47,965	$57,024	$62,966	$74,797	$89,613	$123,063
Average Income	$62,481	($1,104)	$8,082	$12,606	$17,483	$25,001	$34,762	$44,734	$59,253	$74,602	$89,140	$108,503	$132,750	$241,739
	Current Code													
Tax Base	$13,866	$6,064	$5,616	$5,489	$7,130	$8,374	$10,519	$12,001	$13,798	$17,134	$17,698	$22,058	$27,419	$34,061
Taxes Paid	$831	$363	$336	$329	$427	$502	$631	$720	$827	$1,028	$1,061	$1,323	$1,645	$2,043
Taxes Paid (% of Income)	1.33		4.17	2.61	2.45	2.01	1.82	1.61	1.40	1.38	1.19	1.22	1.24	0.85
Ratio to 2nd Highest Bracket	1.07	0.00	3.36	2.11	1.97	1.62	1.47	1.30	1.13	1.11	0.96	0.98	1.00	0.68
Taxes Paid (% of Expenditures)	1.73	1.75	1.84	1.65	1.72	1.72	1.78	1.77	1.73	1.80	1.69	1.77	1.84	1.66
	Proposal 1 (Current + Consumer Services + Utilities)													
Tax Base	$18,070	$7,780	$7,347	$7,621	$9,879	$11,183	$13,909	$15,572	$17,854	$21,737	$22,783	$28,077	$34,323	$45,015
Taxes Paid	$1,026	$436	$408	$419	$546	$620	$781	$878	$1,011	$1,240	$1,297	$1,612	$1,980	$2,605
Taxes Paid (% of Income)	1.64		5.05	3.33	3.13	2.48	2.25	1.96	1.71	1.66	1.46	1.49	1.49	1.08
Ratio to 2nd Highest Bracket	1.10		3.38	2.23	2.10	1.66	1.51	1.32	1.14	1.11	0.98	1.00	1.00	0.72
Taxes Paid (% of Expenditures)	2.13	2.10	2.23	2.11	2.19	2.13	2.20	2.16	2.11	2.17	2.06	2.16	2.21	2.12
	Proposal 2 (Current + Consumer Services + Utilities + Food at Home)													
Tax Base	$21,175	$9,505	$9,214	$9,531	$12,063	$13,574	$16,517	$18,442	$21,009	$25,009	$26,583	$32,466	$39,092	$50,735
Taxes Paid	$1,201	$520	$492	$503	$651	$743	$927	$1,043	$1,195	$1,434	$1,523	$1,875	$2,266	$2,949
Taxes Paid (% of Income)	1.92		6.09	3.99	3.73	2.97	2.67	2.33	2.02	1.92	1.71	1.73	1.71	1.22
Ratio to Highest Bracket	1.13	0.00	3.57	2.34	2.18	1.74	1.56	1.37	1.18	1.13	1.00	1.01	1.00	0.71
Taxes Paid (% of Expenditures)	2.50	2.51	2.69	2.53	2.61	2.55	2.61	2.57	2.49	2.51	2.42	2.51	2.53	2.40

Source: Authors' calculations using the Consumer Expenditure Survey (Bureau of Labor Statistics) 2010 prepublication tables.

Table A. 4.2A: State Income Tax Burdens for Single Filers (2010)

Panel A: State Tax Payments

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**28**	**1105**	**2410**	**3715**	**5063**
Alabama	283	840	1640	2393	3131
Georgia	158	1057	2365	3715	5065
Illinois	223	666	1391	2116	2841
Indiana	284	799	1632	2465	3298
Mississippi	75	704	1829	2954	4079
Missouri	61	778	1884	3128	4435
North Carolina	287	1280	2857	4638	6417
Ohio	0	516	1518	2602	3896
South Carolina	0	736	2478	4053	5628
Tennessee	0	52	172	292	412
Virginia	171	1000	2291	3584	4878
West Virginia	25	840	2145	3740	5365

Panel B: State Tax Payments (%Income)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0.3**	**4.4**	**4.8**	**5.0**	**5.1**
Alabama	2.8	3.4	3.3	3.2	3.1
Georgia	1.6	4.2	4.7	5.0	5.1
Illinois	2.2	2.7	2.8	2.8	2.8
Indiana	2.8	3.2	3.3	3.3	3.3
Mississippi	0.7	2.8	3.7	3.9	4.1
Missouri	0.6	3.1	3.8	4.2	4.4
North Carolina	2.9	5.1	5.7	6.2	6.4
Ohio	0.0	2.1	3.0	3.5	3.9
South Carolina	0.0	2.9	5.0	5.4	5.6
Tennessee	0.0	0.2	0.3	0.4	0.4
Virginia	1.7	4.0	4.6	4.8	4.9
West Virginia	0.2	3.4	4.3	5.0	5.4

Panel C: State Tax Payments (Relative to KY)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Alabama	3.8	1.2	0.9	0.8	0.8
Georgia	2.1	1.5	1.3	1.3	1.2
Illinois	3.0	0.9	0.8	0.7	0.7
Indiana	3.8	1.1	0.9	0.8	0.8
Mississippi	1.0	1.0	1.0	1.0	1.0
Missouri	0.8	1.1	1.0	1.1	1.1
North Carolina	3.8	1.8	1.6	1.6	1.6
Ohio	0.0	0.7	0.8	0.9	1.0
South Carolina	0.0	1.0	1.4	1.4	1.4
Tennessee	0.0	0.1	0.1	0.1	0.1
Virginia	2.3	1.4	1.3	1.2	1.2
West Virginia	0.3	1.2	1.2	1.3	1.3

Notes: Estimates are from NBER and are based on calculations using the TAXSIM program.

Table A.4.2B: State Income Tax Burdens for Joint Filers with No Dependents (2010)

Panel A: State Tax Payments

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0**	**1035**	**2288**	**3561**	**4870**
Alabama	10	821	1869	2814	3642
Georgia	24	809	2309	3809	5309
Illinois	156	612	1337	2062	2787
Indiana	231	768	1601	2434	3267
Mississippi	0	355	1531	2638	3745
Missouri	0	430	1702	2954	4287
North Carolina	-21	897	2605	4355	6295
Ohio	0	445	1437	2519	3794
South Carolina	0	206	1894	3644	5394
Tennessee	0	0	104	224	344
Virginia	0	790	2190	3590	4994
West Virginia	0	765	2036	3622	5247

Panel B: State Tax Payments (%Income)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0.0**	**4.1**	**4.6**	**4.7**	**4.9**
Alabama	0.1	3.3	3.7	3.8	3.6
Georgia	0.2	3.2	4.6	5.1	5.3
Illinois	1.6	2.4	2.7	2.7	2.8
Indiana	2.3	3.1	3.2	3.2	3.3
Mississippi	0.0	1.4	3.1	3.5	3.7
Missouri	0.0	1.7	3.4	3.9	4.3
North Carolina	-0.2	3.6	5.2	5.8	6.3
Ohio	0.0	1.8	2.9	3.4	3.8
South Carolina	0.0	0.8	3.8	4.9	5.4
Tennessee	0.0	0.0	0.2	0.3	0.3
Virginia	0.0	3.2	4.4	4.8	5.0
West Virginia	0.0	3.1	4.1	4.8	5.2

Panel C: State Tax Payments (Relative to KY)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Alabama	NA	2.3	1.2	1.1	1.0
Georgia	NA	2.3	1.5	1.4	1.4
Illinois	NA	1.7	0.9	0.8	0.7
Indiana	NA	2.2	1.0	0.9	0.9
Mississippi	NA	1.0	1.0	1.0	1.0
Missouri	NA	1.2	1.1	1.1	1.1
North Carolina	NA	2.5	1.7	1.7	1.7
Ohio	NA	1.3	0.9	1.0	1.0
South Carolina	NA	0.6	1.2	1.4	1.4
Tennessee	NA	0.0	0.1	0.1	0.1
Virginia	NA	2.2	1.4	1.4	1.3
West Virginia	NA	2.2	1.3	1.4	1.4

Notes: Estimates are from NBER and are based on calculations using the TAXSIM program.

Table A.4.2C: State Income Tax Burdens for Joint Filers with Two Dependents (2010)

Panel A: State Tax Payments

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0**	**699**	**2252**	**3524**	**4834**
Alabama	0	776	1874	2819	3697
Georgia	0	483	1983	3483	4983
Illinois	-116	334	1228	1953	2678
Indiana	-216	310	1448	2281	3114
Mississippi	0	243	1397	2504	3611
Missouri	0	304	1633	2884	4160
North Carolina	-184	275	2107	4038	5915
Ohio	0	301	1276	2357	3592
South Carolina	0	0	1432	3182	4932
Tennessee	0	0	104	224	344
Virginia	0	17	2093	3493	4897
West Virginia	0	620	1819	3387	5012

Panel B: State Tax Payments (%Income)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0.0**	**2.8**	**4.5**	**4.7**	**4.8**
Alabama	0.0	3.1	3.7	3.8	3.7
Georgia	0.0	1.9	4.0	4.6	5.0
Illinois	-1.2	1.3	2.5	2.6	2.7
Indiana	-2.2	1.2	2.9	3.0	3.1
Mississippi	0.0	1.0	2.8	3.3	3.6
Missouri	0.0	1.2	3.3	3.8	4.2
North Carolina	-1.8	1.1	4.2	5.4	5.9
Ohio	0.0	1.2	2.6	3.1	3.6
South Carolina	0.0	0.0	2.9	4.2	4.9
Tennessee	0.0	0.0	0.2	0.3	0.3
Virginia	0.0	0.1	4.2	4.7	4.9
West Virginia	0.0	2.5	3.6	4.5	5.0

Panel C: State Tax Payments (Relative to KY)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Alabama	NA	3.2	1.3	1.1	1.0
Georgia	NA	2.0	1.4	1.4	1.4
Illinois	NA	1.4	0.9	0.8	0.7
Indiana	NA	1.3	1.0	0.9	0.9
Mississippi	NA	1.0	1.0	1.0	1.0
Missouri	NA	1.3	1.2	1.2	1.2
North Carolina	NA	1.1	1.5	1.6	1.6
Ohio	NA	1.2	0.9	0.9	1.0
South Carolina	NA	0.0	1.0	1.3	1.4
Tennessee	NA	0.0	0.1	0.1	0.1
Virginia	NA	0.1	1.5	1.4	1.4
West Virginia	NA	2.6	1.3	1.4	1.4

Notes: Estimates are from NBER and are based on calculations using the TAXSIM program.

Table A.4.2D: State Income Tax Burdens for Elderly (>65) (2010)

Panel A: State Tax Payments

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0**	**1068**	**2373**	**3678**	**5027**
Alabama	283	849	1654	2393	3131
Georgia	0	649	2029	3138	4368
Illinois	204	639	1364	2089	2814
Indiana	253	753	1601	2434	3267
Mississippi	34	636	1761	2886	4011
Missouri	-966	421	2026	3128	4435
North Carolina	254	1232	2982	4638	6417
Ohio	0	471	1473	2557	3850
South Carolina	0	0	1448	3103	4678
Tennessee	0	52	172	292	412
Virginia	0	376	2045	3543	4836
West Virginia	0	548	1711	3269	4894

Panel B: State Tax Payments (%Income)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Kentucky	**0.0**	**4.3**	**4.7**	**4.9**	**5.0**
Alabama	2.8	3.4	3.3	3.2	3.1
Georgia	0.0	2.6	4.1	4.2	4.4
Illinois	2.0	2.6	2.7	2.8	2.8
Indiana	2.5	3.0	3.2	3.2	3.3
Mississippi	0.3	2.5	3.5	3.8	4.0
Missouri	-9.7	1.7	4.1	4.2	4.4
North Carolina	2.5	4.9	6.0	6.2	6.4
Ohio	0.0	1.9	2.9	3.4	3.9
South Carolina	0.0	0.0	2.9	4.1	4.7
Tennessee	0.0	0.2	0.3	0.4	0.4
Virginia	0.0	1.5	4.1	4.7	4.8
West Virginia	0.0	2.2	3.4	4.4	4.9

Panel C: State Tax Payments (Relative to KY)

Income ($1,000)	$ 10	$ 25	$ 50	$ 75	$ 100
Alabama	NA	1.3	0.9	0.8	0.8
Georgia	NA	1.0	1.2	1.1	1.1
Illinois	NA	1.0	0.8	0.7	0.7
Indiana	NA	1.2	0.9	0.8	0.8
Mississippi	NA	1.0	1.0	1.0	1.0
Missouri	NA	0.7	1.1	1.1	1.1
North Carolina	NA	1.9	1.7	1.6	1.6
Ohio	NA	0.7	0.8	0.9	1.0
South Carolina	NA	0.0	0.8	1.1	1.2
Tennessee	NA	0.1	0.1	0.1	0.1
Virginia	NA	0.6	1.2	1.2	1.2
West Virginia	NA	0.9	1.0	1.1	1.2

Notes: Estimates are from NBER and are based on calculations using the TAXSIM program.

Table A.5.1: Growth in Personal Income per Capita, Kentucky and Competitor States, (Constant 2011 $)

Area	Annual Growth Rate (%)					Total Growth (%)	
	'69 - '11	'69-'80	'81-'90	'91-'00	'01-'11	'69 - '11	'01-'11
Kentucky	**3.13**	**2.95**	**2.62**	**3.28**	**0.62**	**131.65 (9)**	**6.24 (7)**
United States	2.89	2.48	2.77	3.22	0.70	121.50	7.02
Competitor States	3.07	2.65	3.04	3.25	0.61	128.92	6.12
Alabama	3.77	3.50	3.39	2.69	1.06	158.47 (3)	10.61 (3)
Georgia	3.19	2.65	3.92	3.66	-0.15	133.82 (8)	-1.54 (13)
Illinois	2.57	2.05	2.67	3.35	0.63	107.75 (10)	6.30 (6)
Indiana	2.29	2.05	2.53	3.29	0.15	96.37(13)	1.51 (12)
Mississippi	4.12	3.73	2.33	3.58	1.29	173.08 (1)	12.87 (2)
Missouri	2.82	2.38	2.50	3.15	0.69	118.56 (11)	6.89 (5)
North Carolina	3.38	2.72	4.00	3.67	0.21	142.13 (7)	2.06 (11)
Ohio	2.31	2.18	2.60	3.03	0.33	97.06 (12)	3.32 (10)
South Carolina	3.42	2.97	3.69	3.34	0.51	143.44 (6)	5.12 (9)
Tennessee	3.62	3.14	3.49	3.39	0.61	151.96 (4)	6.13 (8)
Virginia	3.88	3.39	3.43	3.04	1.05	163.06 (2)	10.54 (4)
West Virginia	3.45	3.61	2.12	2.66	1.38	144.80 (5)	13.78 (1)

Notes: The category competitor states is a weighted average of income of the competitor states.
Source: Authors' calculations and Bureau of Economic Analysis Regional Economic Information System (REIS) files.

Table A.5.2: Growth in Population, Kentucky and Competitor States

Area	Annual Growth Rate (%)					Total Growth (%)	
	'69 - '11	'69-'80	'81-'90	'91-'00	'01-'11	'69 - '11	'01-'11
Kentucky	**0.87**	**1.33**	**0.07**	**0.98**	**0.74**	**36.63 (7)**	**7.40 (7)**
United States	1.30	1.17	0.98	1.28	0.93	54.79	9.34
Competitor States	0.73	0.46	0.37	1.07	0.75	30.63	7.47
Alabama	0.94	1.22	0.37	0.96	0.75	39.61 (6)	7.50 (6)
Georgia	2.75	1.87	1.88	2.63	1.72	115.67 (1)	17.17 (2)
Illinois	0.39	0.33	0.01	0.83	0.30	16.58 (11)	3.05 (11)
Indiana	0.64	0.61	0.16	0.94	0.64	26.71 (10)	6.35 (9)
Mississippi	0.81	1.25	0.17	1.07	0.44	34.17 (8)	4.40 (10)
Missouri	0.70	0.55	0.44	0.94	0.66	29.54 (9)	6.55 (8)
North Carolina	2.19	1.57	1.32	2.12	1.76	91.94 (2)	17.62 (1)
Ohio	0.22	0.20	0.08	0.42	0.14	9.30 (12)	1.38 (13)
South Carolina	1.95	2.00	1.13	1.41	1.51	82.07 (3)	15.11 (3)
Tennessee	1.53	1.64	0.64	1.65	1.13	64.31 (5)	11.35 (5)
Virginia	1.80	1.49	1.58	1.42	1.25	75.48 (4)	12.48 (4)
West Virginia	0.15	1.07	-0.92	0.05	0.30	6.26 (13)	2.99 (12)

Notes: The category competitor states is a weighted average of income of the competitor states.
Source:Authors' calculations and Bureau of Economic Analysis Regional Economic Information System (REIS) files.

Table A.5.3: Private Earnings per Employee

Area	Annual Growth Rate (%)					Total Growth (%)	
	69-'10	'69-'80	'81-'90	'91-'00	01-'10	69-'10	01-'10
Kentucky	**0.84**	**1.39**	**-0.05**	**2.09**	**-0.20**	**34.49**	**-1.77**
United States	1.02	0.60	0.93	2.76	-0.15	41.64	-1.31
Competitor States	1.02	0.96	0.66	2.36	-0.08	41.70	-0.69
Alabama	1.11	1.52	0.73	1.60	0.01	45.55	0.09
Georgia	1.40	1.25	1.68	3.15	-0.88	57.33	-7.95
Illinois	0.91	0.74	0.95	2.56	-0.13	37.31	-1.21
Indiana	0.54	0.53	-0.13	2.02	-0.17	22.26	-1.54
Mississippi	1.21	1.65	0.35	2.08	0.04	49.41	0.34
Missouri	0.90	0.44	0.62	2.50	0.21	36.90	1.87
North Carolina	1.47	1.09	1.43	3.08	-0.23	60.40	-2.03
Ohio	0.51	0.37	0.24	1.77	-0.08	21.06	-0.70
South Carolina	1.06	1.22	1.17	2.23	-0.58	43.53	-5.24
Tennessee	1.47	1.17	1.01	2.66	0.20	60.27	1.79
Virginia	1.90	1.11	1.51	3.28	0.32	77.75	2.84
West Virginia	0.58	1.73	-0.67	0.61	0.50	23.83	4.52

Notes: The category competitor states is a weighted average of income of the competitor states.
Source: Authors' calculations and Bureau of Economic Analysis Regional Economic Information System (REIS) files.

Table A.9.1: Services Considered for Taxation and Estimate Revenue

	Establishments	Employees	Tax Revenue (2012 $1,000)
Personal Services	**2,282**	**16,359**	**70,120**
Funeral homes and funeral services	367	2,220	18,770
Industrial launderers	38	2,144	12,080
Beauty salons	772	4,295	11,630
Drycleaning and laundry services (except coin-operated)	266	2,199	6,080
Linen supply	12	842	4,550
Parking lots and garages	97	799	3,720
Cemeteries and crematories	109	649	3,280
Other personal care services	205	1,202	2,710
Coin-operated laundries and drycleaners	129	561	2,170
Pet care (except veterinary) services	125	708	1,690
Diet and weight reducing centers	30	244	1,330
All other personal services	53	183	930
Barber shops	34	137	410
Photofinishing laboratories (except one-hour)	11	79	380
Nail salons	29	73	300
One-hour photofinishing	5	24	90
Automotive Repair and Services (non-commercial)	**2,016**	**10,740**	**65,850**
General automotive repair	872	3,958	27,640
Automotive body, paint, and interior repair and maintenance	456	2,476	17,940
Automotive oil change and lubrication shops	158	1,208	5,170
Car washes	191	1,836	4,900
Automotive glass replacement shops	101	421	3,310
Other automotive mechanical and electrical repair and maintenance	76	283	2,180
Automotive transmission repair	91	298	2,130
All other automotive repair and maintenance	25	120	1,680
Automotive exhaust system repair	46	140	900
Other Residential and Consumer Repair Services	**236**	**1491**	**5,450**
Appliance repair and maintenance	40	182	1,330
Other personal and household goods repair and maintenance	87	318	1,710
Consumer electronics repair and maintenance	37	792	1,350
Home and garden equipment repair and maintenance	26	76	550
Reupholstery and furniture repair	35	109	460
Footwear and leather goods repair	11	14	50
Amusements and Recreational Services	**705**	**8,286**	**34,990**
Remediation services	48	1,158	11,470
Fitness and recreational sports centers	306	3,212	7,790
Golf courses and country clubs	144	1,793	6,960
All other amusement and recreation industries	101	736	3,360
Marinas	49	360	2,960
Bowling centers	57	1,027	2,450

Source: Authors' calculations based on Governor's Office for Economic Analysis and 2007 Economic Census, Census Bureau, Department of Commerce.

KyCPA Blue Ribbon Tax Commission Presentation

October 2, 2012

Introduction

Lt. Governor Abramson and members of the Commission, good afternoon. My name is Bill Meyer and I am the president of the Kentucky Society of CPAs. With me today is Penny Gold, chief executive officer of the Society, and Byron Largen, the chair of our Tax Committee. Founded in 1924, KyCPA is a statewide, non-profit professional organization serving nearly 5,000 CPAs in public accounting firms, business, industry, government, and education. We strive not only to advance policies that support the CPA profession, but also those that help the businesses and individuals we serve. We believe in a tax system that is simple, equitable, transparent, predictable and competitive.

KyCPA is proud to serve as an official advisory body to this Commission. Our members are uniquely qualified to analyze tax policy alternatives and to articulate their likely effects. Our organization, more than most, sincerely appreciates the monumental task you have before you.

As you know, KyCPA staff and members attended every Commission meeting around the state. You probably recognize many of the faces sitting behind me. They met with representatives of the administration as well as the Commission's consultants. They also distributed a booklet to you in March titled, "Tax Policies that Make Sense." Although drafted by our Tax Committee in 2009, many of the principles and recommendations contained in this document are still relevant today. We encourage you to consider these policies as you develop your final report. If you need an extra copy, let us know.

On September 19, the consultants provided a 114-page report with numerous options to change Kentucky's tax code. Some of these changes are minor; others major. Some may hit Kentuckians' pocketbooks positively; others negatively. All of the options, however, require thoughtful consideration. We agree with the consultants that the impact of these options must be considered collectively, and not in isolation. With all of the challenges Kentucky faces, from shoring up our pension deficit to improving education to cultivating a robust business climate, the stakes are high.

Our brief presentation today includes some observations related to the consultants' report and other considerations from a tax preparer's perspective. We see our role in this process as that of a trusted adviser and a sounding board as you tackle the technicalities and practical consequences of adopting various tax options.

Federal Code Conformity and Uneven Penalties and Interest

I want to start with a couple of issues that haven't received a lot of attention, but would increase the simplicity and fairness of our tax code.

First, the need for conformity with the federal tax code is long overdue. We were pleased to see this listed as an option in the consultants' report. The last time Kentucky's tax laws were synchronized with the federal code was 2006. The cost and complexity of complying with tax laws so vastly different from the federal system sets us apart from other states, but not in a good way. Businesses around the country have to hunt down information about Kentucky's unique and outdated requirements, hindering compliance. Kentucky-based businesses ultimately pay more for filing services because of the delays caused by a tax code so out of step with the rest of the country.

KyCPA also believes Kentucky's estimated tax rules should be changed to mimic federal rules that provide a safe haven for estimated tax payments based on prior year tax or current year actual income. It is much more difficult to effectively calculate Kentucky's estimated tax payments than it is for federal taxes.

Second, to ensure fairness, Kentucky should return to a balanced interest rate on taxes owed to and by the Commonwealth. On page 65 of the consultants' report, a 2010 Council of State Taxation (COST) study lists "equalized rates on refunds and assessments" as one of the criteria for fair tax administration.

Historically, the state did just that: it paid the same interest on the tax refunds due to a citizen as the interest assessed against a taxpayer who owed taxes to the state. A few years ago, however, language was added to the Kentucky Revised Statutes that requires taxpayers to pay an interest rate to the state of "prime *plus* 2 percent," while the state can hold a taxpayer's refund and pay him or her an interest rate of only "prime *minus* 2 percent." The interest statute should account only for the value of money – it is not a penalty. So, to us, this 4 percent differential does not seem fair.

Single Sales Factor Apportionment and Destination Sourcing

Another option in the consultants' report is the adoption of a single factor apportionment formula based on sales for multi-state companies. This has long been advocated by economic developers to increase our state's competitiveness. If adopted, such a formula would shift the corporate tax burden from businesses in Kentucky whose customers are outside Kentucky, to non-Kentucky businesses that sell products and services in the Commonwealth. This shift in burden should

encourage Kentucky-based businesses to grow – increasing jobs and boosting state payroll, income, property and sales taxes.

Listed as a separate option in the report is the utilization of "destination sourcing" (also known as "market sourcing") as the method for sourcing revenue for service businesses. The consultants noted that the single sales factor apportionment formula and this option needed to be combined. We want to underscore the importance of that combination. If you choose to adopt the single sales factor approach, it is essential that destination sourcing for service businesses also be adopted. Destination sourcing generally tracks the actual economics of a business – sales are apportioned based on customer locations.

Kentucky's current apportionment method for service businesses is referred to as "cost of performance." This apportionment method is riddled with complexity and compliance issues, and many states have moved to destination sourcing to make it easier for businesses to comply. Apportionment methodologies are complicated and beyond the scope of our testimony today. We have provided additional information to the administration on this issue and will gladly offer further assistance if needed.

Gross Receipts Tax

The adoption of a gross receipts tax is another option in the consultants' report. Gross receipts taxes, such as the Limited Liability Entity Tax (LLET), are considered somewhat unfair as compared to income taxes. Some people believe all companies should shoulder the corporate tax burden regardless of whether they are profitable or not. However, as compared to gross receipts taxes, income taxes are generally viewed as more equitable because profitable companies shoulder the burden of the tax. As a tax preparer, one of the most difficult things I have to do is to call a client who has been suffering economic hardship and cash flow difficulties, and tell him that he owes a significant LLET tax liability. In that vein, a number of our members believe you should consider repealing the LLET on businesses experiencing a net loss.

A gross receipts tax is similar to a sales tax in that it is based on a company's sales. The primary difference between a gross receipts tax and a sales tax is that, unlike a gross receipts tax, a sales tax is directly billed to the purchaser on each sale. The imposition of a gross receipts tax, like the LLET, results in multiple levels of tax as a good or service passes through the distribution chain, which is often referred to as "taxes-on-taxes" or "pyramiding." Pyramiding often adversely impacts Kentucky-based distribution chains much more than out-of-state-based distribution chains.

The consultants' report expressed concern about the use of multiple companies to avoid the LLET and suggested as an option to reduce the $3 million exemption to $1 million. It should be noted that this concern has already been addressed by computing each company's LLET exemption by reference to the amount of its affiliated group's total gross receipts. Therefore, tax avoidance does not appear to be an issue, as adding new affiliated companies does not result in additional LLET exemptions.

Business-to-Business Transactions

Expanding on the topic of pyramiding, we acknowledge and recognize as good tax policy the consultants' recommendation to avoid the taxation of business-to-business, or B2B, transactions. There has been a lot of attention lately, especially in the media, on tax expenditures – what many people like to call "loopholes." While it's easy to get starry-eyed when reviewing the state's tax expenditure report in seeking new revenue, let's be clear: not all tax expenditures should be considered "loopholes." Although exemptions should be granted sparingly and regularly studied for their appropriateness and effectiveness, many are in place to prevent pyramiding.

We agree with the consultants that purchases of business inputs used for the manufacture of goods are not, and should not be, taxed. We believe this because sound implementation of a consumption tax dictates that the final product – not manufacturing, distribution, and retail inputs – should be taxed. If B2B transactions were taxed, Kentucky products would be at a pricing disadvantage, hurting Kentucky businesses, employment, and consumers.

We also agree with the consultants that taxing professional and other services that are easily portable and available across state lines could severely hurt the competitiveness of Kentucky-based companies. In addition, the revenue growth associated with expanding the sales tax to other selected services should be carefully weighed against the compliance burden on small and midsize businesses.

Individual and Corporate Tax Rate Parity

There has been some talk about changing the individual and/or corporate income tax rates. During the most recent fiscal year, corporate income taxes accounted for $374 million in state revenue, or just over 4 percent of the total. And this is an increase from the previous fiscal year, when corporate income taxes amounted to only 3.4 percent of total revenue.

This may make it appear that businesses do not make a very big contribution to state revenue. Sometimes, the tax paid by corporations is equated with the tax paid

by all businesses. But it is important to note that tax on business profits for partnerships, S corporations, and LLCs is included in the individual income revenue line in the state's revenue report. Individual income taxes total more than $3.5 billion or 38.6 percent of total revenue – the largest category shown in General Fund Receipts.

Currently, the maximum corporate and individual income tax rates are the same – 6 percent. We believe it is important that the top corporate and individual tax rates remain at parity. Parity means the income tax status of all businesses, large and small, have an equal tax burden based on their income, thereby leveling the playing field for all businesses.

Another option in the consultants' report is the idea of lowering tax rates. Understanding an offset would be needed, lowering the individual and corporate tax rates could increase Kentucky's competitive position as compared to other states. Because business owners and CEOs often make site selections based upon their own personal tax liability, a reduction of the tax rates could build a more favorable business climate and increase the number of Kentucky-based businesses.

Local Taxes

We are pleased the consultants recognized the impact of local taxes on our tax system. Local taxes on income, especially when coupled with state income taxes, greatly influence where individuals and businesses decide to locate. Not only do local tax rates have an impact, but perhaps more importantly, so do the administration of such taxes. Kentucky's local occupational tax and license fee system includes hundreds of jurisdictions – including county, city, and special taxing authorities – each with their own forms, rules, and rates. I have a client that made slightly more than $50,000 last year. He files 70 separate local tax returns in Kentucky. My firm's fees for preparation of all these returns was about $6,000, and exceeded fees for preparation of the federal and state income tax returns.

The current local occupational tax system results in a substantial compliance burden on businesses and individuals operating and working in multiple jurisdictions. Additionally, Kentucky's local jurisdictions impose a tax on tangible personal property, including inventory. These local property taxes often have much more of an impact on business location decisions than the state property tax. Unless Kentucky's current local tax system is more centralized and streamlined, the option of imposing a local sales tax on top of the local occupational and property taxes would create a much heavier compliance burden (and more confusion). If a local sales tax is recommended, we also encourage this commission to recommend adopting uniform standards across the state.

Conclusion

Again, thank you for the opportunity to speak with you today. We appreciate your service on this Commission and to the Commonwealth, and applaud your efforts to seek a better tax system. As an organization, we stand ready to advise you, the administration, the consultants, and members of the Kentucky General Assembly as this process moves forward. We are now available to answer any questions.

KENTUCKY DEPARTMENT OF REVENUE

Presented by:
Lori H. Flanery, Secretary
Finance and Administration Cabinet
to the
Governor's Blue Ribbon Commission on Tax Reform
October 2, 2012

1

MISSION STATEMENTS

Finance and Administration Cabinet (FAC) Mission Statement

Through leadership and innovation, provide centralized support services to all agencies of state government, other government organizations, and the citizens of the Commonwealth.

Dept. of Revenue (DOR) Mission Statement

Administer tax laws, collect revenue, and **provide services** in a fair, courteous, and efficient manner for the benefit of the Commonwealth and its citizens.

2

Complexity of Taxes and Tax Reform

Fairness

Competitiveness

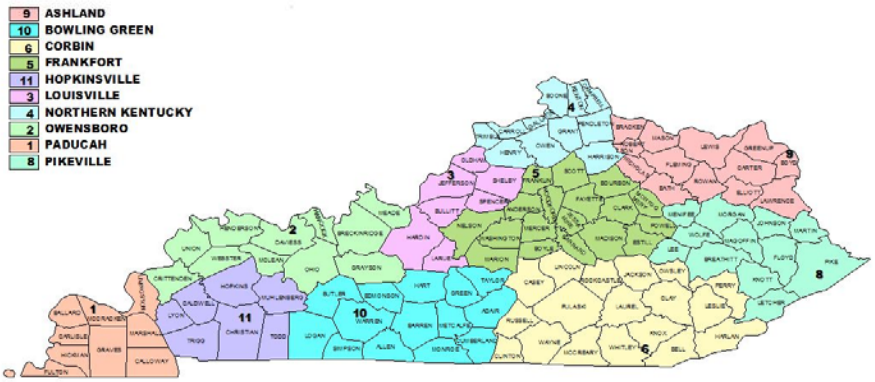
Simplicity and Compliance

Elasticity

Adequacy

3

Department of Revenue Service Centers



Department of Revenue Responsibilities

Administers more than 70 taxes and fees

Taxpayer Assistance
Registration
Document Processing
Compliance
Protest Resolution
Collections
Criminal Investigations

www.revenue.ky.gov

5

Department of Revenue
Service & Compliance Advancements

- **On-line services to improve efficiency:**
  - E-filing for individuals & businesses
  - Credit card payments for taxes
  - Business tax registrations via onestop.ky.gov

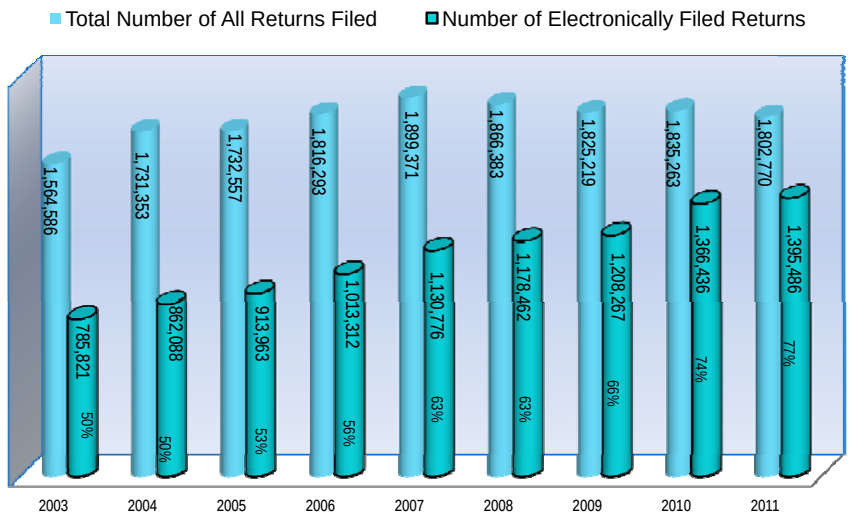
6

Department of Revenue
Service & Compliance Advancements

- **Automated compliance & collection programs:**
  - Tax Amnesty Program
  - Refund offsets against child support debt
  - Federal/state debt offset program
  - Enterprise collections initiative
  - Computer Assisted Audit Program

7

Individual Income Tax Returns Filed by Tax Year
Growth in eFiling 2003 - 2011



Department of Revenue
Compliance & Collection Initiatives

- **Tax Amnesty:**
  - Oct. 1 to Nov. 30, 2012
  - Eligible tax periods ending after Dec. 1, 2001 & prior to Oct. 1, 2011
  - Amnesty.ky.gov
  - 855-KY-TAXES

KENTUCKY taxamnesty
Good for you. Good for Kentucky.

9

Department of Revenue
Future Service & Compliance Initiatives

- Expanded registration and electronic filing services will eventually be available at:

  onestop.ky.gov

  Kentucky One Stop BUSINESS PORTAL

- Data warehouse for compliance and collection efforts

10

Department of Revenue
Observations on Current Tax Code

- Complexity
- Tax base erosion
- More than 70 taxes and fees administered
- 625 forms & related schedules
- Significant number of exemptions
- Frequent litigation of tax issues contributes to complexity

11

Department of Revenue
Observations on Current Tax Code

Tax reform is needed to:

- Reduce complexity of the current tax code.
- Reduce the cost of compliance for taxpayers.
- Reduce the Department's cost of administration.
- Increase voluntary compliance.

12

Department of Revenue
Commonly Recurring Litigation Themes

- Sales and Use Tax
- Cigarette and Tobacco Tax
- Limited Liability Entity Tax (LLET)
- Narrow Timeframe for Tax Credits
- Motor Vehicle Usage Tax & Grantor Trust

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Department of Revenue
Suggestions for Tax Reform

Simplicity—

1. Enact an Internal Revenue Code (IRC) update for individual & corporation income taxes.
2. Repeal Rural Electric Cooperative Corporation & Rural telephone Cooperative Corporation Tax.
3. Repeal Distilled Spirits Case Sales Tax

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Department of Revenue
Suggestions for Tax Reform

Simplicity—

4. Eliminate negligible state property tax rates for tangible personal property.
   - Unmanufactured Agriculture Products in Holding (1.5¢)
   - Non-commercial Aircraft /Watercraft (1.5¢)
   - Foreign Trade Zone Property (1.1¢)
   - Livestock & Farm Machinery in Fluidized Beds Energy Facilities (1.1¢)
   - Manufacturer's Raw Materials, Goods in Process, Motor Vehicles held for Sale, Farm Machinery held for Sale, Salvaged Title Vehicles (5¢)

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Department of Revenue
Suggestions for Tax Reform

Fairness –

5. LLC member personal liability and corporate officer liability are not consistent across major taxes.
6. Reduce dealer's compensation on motor fuels tax from 2.25% to 1%.
7. Strengthen the corporation income tax management fee add-back language.

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Department of Revenue
Suggestions for Tax Reform

Fairness –

8. Apply the sales tax on access to pre-written computer software.
9. Apply transient room taxes on entire hotel accommodation price.
10. Tax base erosion: Pari-mutuel tax.

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Property Valuation Administrators

- The Department's partner in property tax administration is the PVA!
- Technology advancements impact each PVA Office.
- DOR reviewing single funding source issue.

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Complexity of Taxes and Tax Reform

Fairness

Competitiveness

Simplicity and Compliance

Elasticity

Adequacy

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Blue Ribbon Commission on Tax Reform

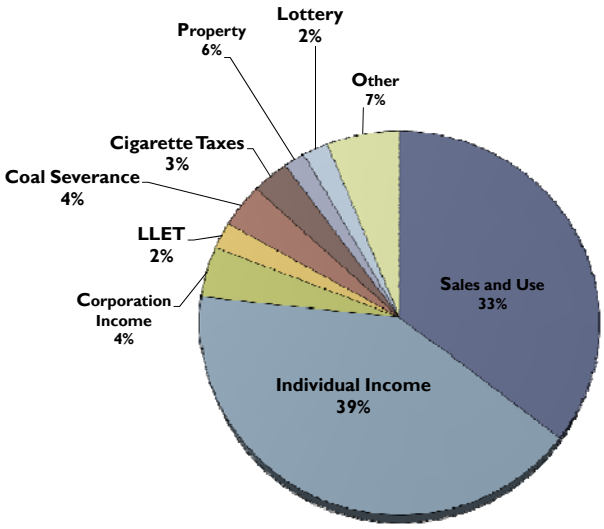
Office of State Budget Director
Mary Lassiter, State Budget Director
John Hicks, Deputy State Budget Director
Kevin Cardwell, Deputy State Budget Director

October 2, 2012

Overview of State Spending Trends

- Background on the State Budget
- Review of Historical Spending
- Recent History – 13 Budget Reduction Actions over 7 Fiscal Years
- Focus on the Future

Composition of FY14 General Fund Estimates by Tax Type



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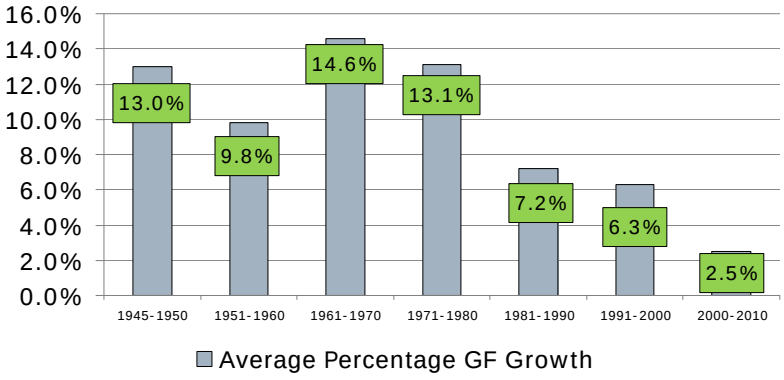
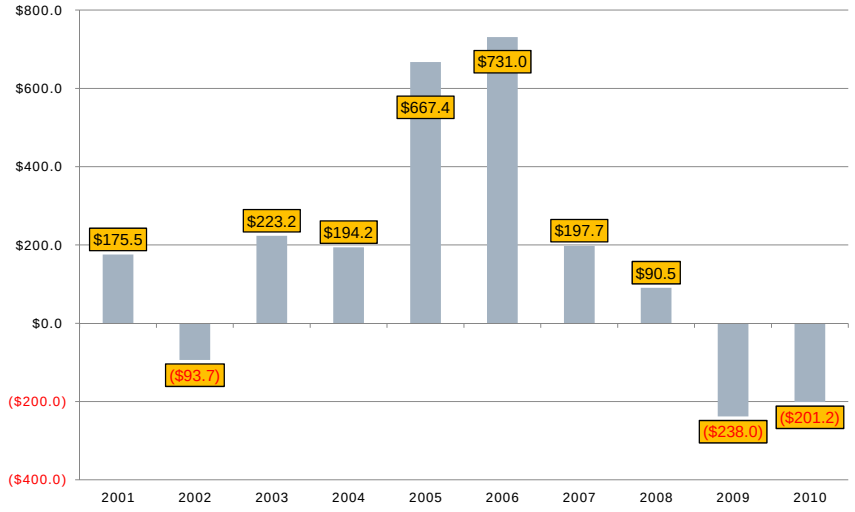
General Fund Revenue Growth by Decade



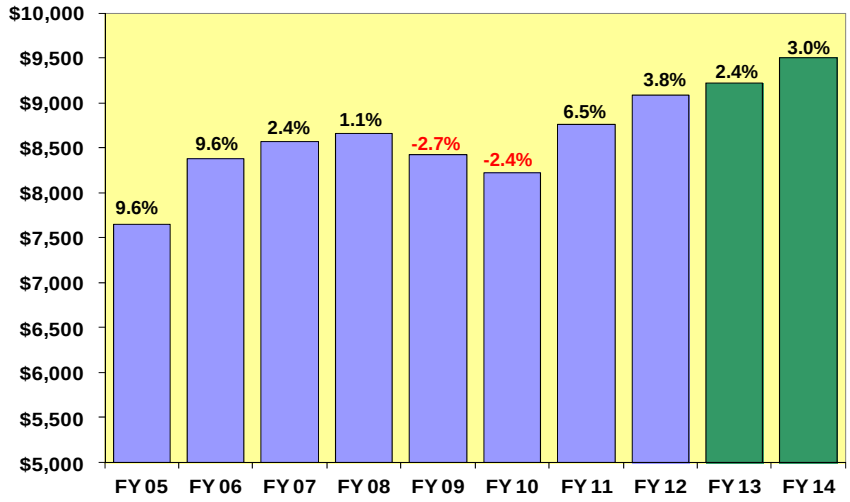
4

General Fund Revenue Increases (Decreases) over the Last Decade ($Millions)



5

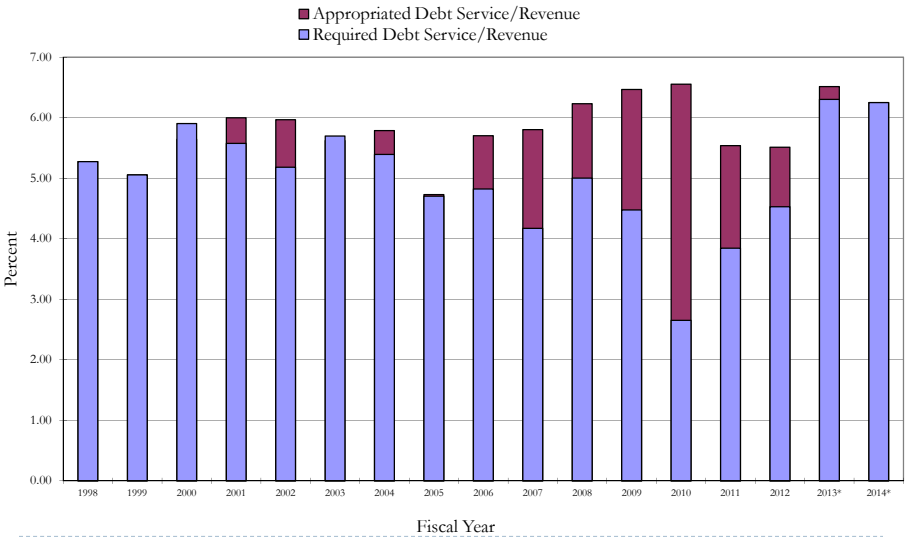
Modest Revenue Growth Predicted (millions and percent change from prior fiscal year)



6

Historical Debt Capacity Ratios with 2012-14 Enacted Budget

(updated as of 10/1/12)



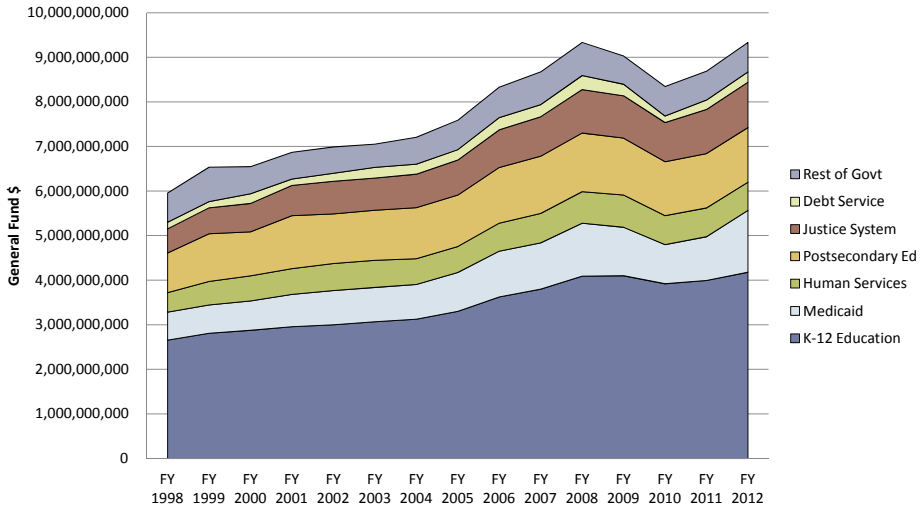
7

Debt Appropriated and Percent of Revenue 2000-2014

Biennium	Total New Debt Budgeted	General	Road	Agency	Percent of Total Revenue
2000-02	$1,046,927,600	$901,202,600	$28,200,000	$117,525,000	5.18
2002-04	$828,936,380	$621,936,380		$207,000,000	5.39
2004-06	$1,906,315,300	$1,204,589,300	$450,000,000	$251,726,000	4.89
2006-08	$2,110,528,000	$1,492,991,000	$350,000,000	$267,537,000	5.16
2008-10	$2,015,494,000	$657,281,000	$535,000,000	$823,213,000	3.08
2010-12	$1,549,199,800	$507,395,800	$522,500,000	$519,304,000	6.47
2012-14	$391,260,000	$335,260,000	$12,500,000	$43,500,000	6.52

8

General Fund Spending – FY 1998-2012



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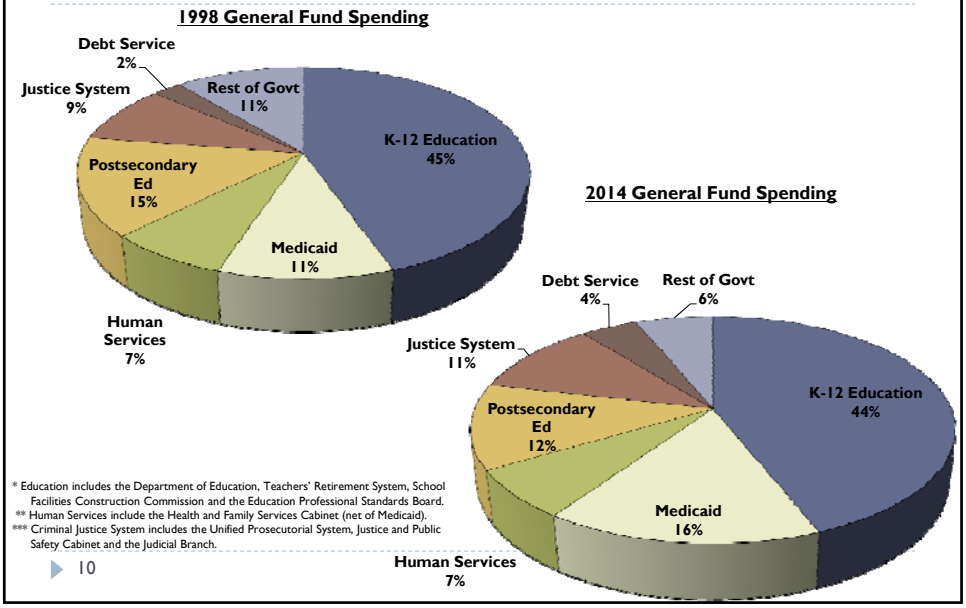
General Fund Spending FY 1998 and FY 2014



* Education includes the Department of Education, Teachers' Retirement System, School Facilities Construction Commission and the Education Professional Standards Board.
** Human Services include the Health and Family Services Cabinet (net of Medicaid).
*** Criminal Justice System includes the Unified Prosecutorial System, Justice and Public Safety Cabinet and the Judicial Branch.

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Spending Growth – FY 1998-2014

- Total General Fund Spending Growth 58%
- Kentucky Personal Income Growth 94%

- K-12 Education 61%
- Medicaid 140%
- Postsecondary Education 32%
- Justice System 93%
- Human Services 54%
- Debt Service 193%
- Rest of Government -8%

11

K-12 Education
Spending Growth – FY 1998-2014

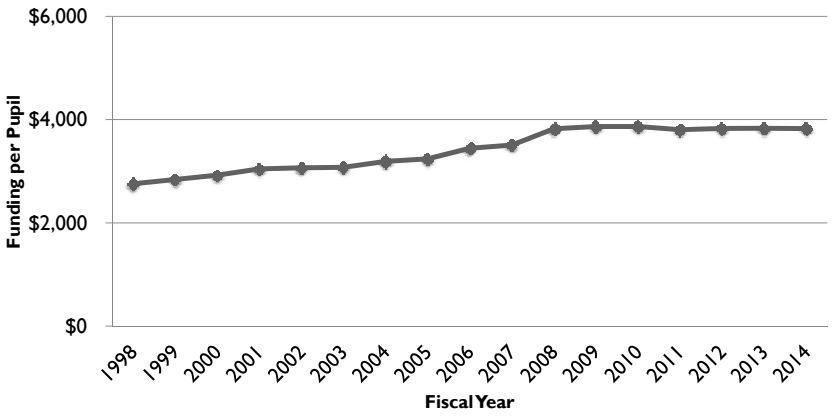
- Total General Fund Spending Growth 58%
- Kentucky Personal Income Growth 94%

- Total K-12 Spending Growth 61%

  - SEEK Formula 42%
  - Health Insurance 208%
  - Retirement 122%
  - School Construction 81%

12

SEEK Funding per Pupil



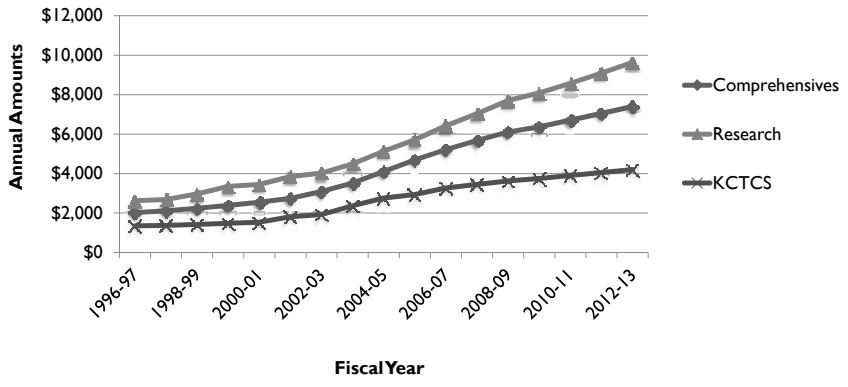
Other K-12 Education Cuts – FY 2008-2014

Other K-12 Education Programs	FY 2008	FY 2014	% Change
Preschool	$75,127,000	$71,315,300	-5.1%
FRYSC's	$51,850,700	$52,148,300	0.6%
Extended School Services	$31,895,500	$12,301,200	-61.4%
Reading Programs	$23,558,100	$17,899,000	-24.0%
Textbooks	$21,700,100	$0	-100.0%
Professional Development	$15,034,700	$5,370,300	-64.3%
Vocational Technical Schools	$11,175,400	$10,954,100	-2.0%
Gifted and Talented	$7,121,500	$6,622,300	-7.0%
Math Achievement	$0	$5,353,600	

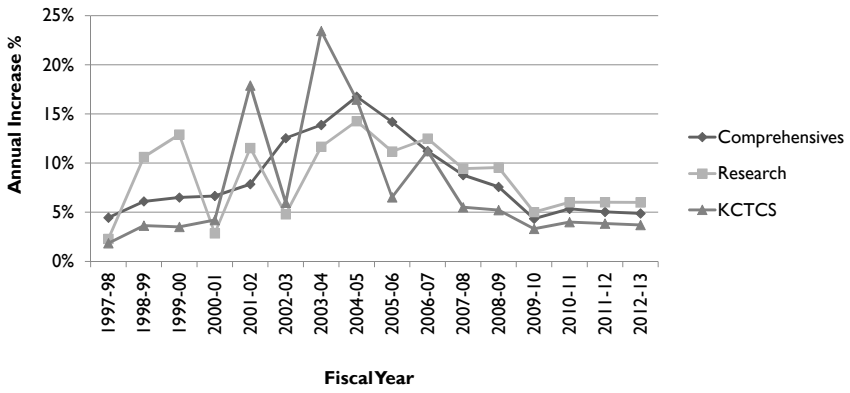
Postsecondary Education Spending Growth – FY 1998-2014

- Total General Fund Spending Growth 58%
- Kentucky Personal Income Growth 94%
- Postsecondary Education Spending Growth 32%
  - Postsecondary Education Institutions 21%
  - Student Financial Aid 561%

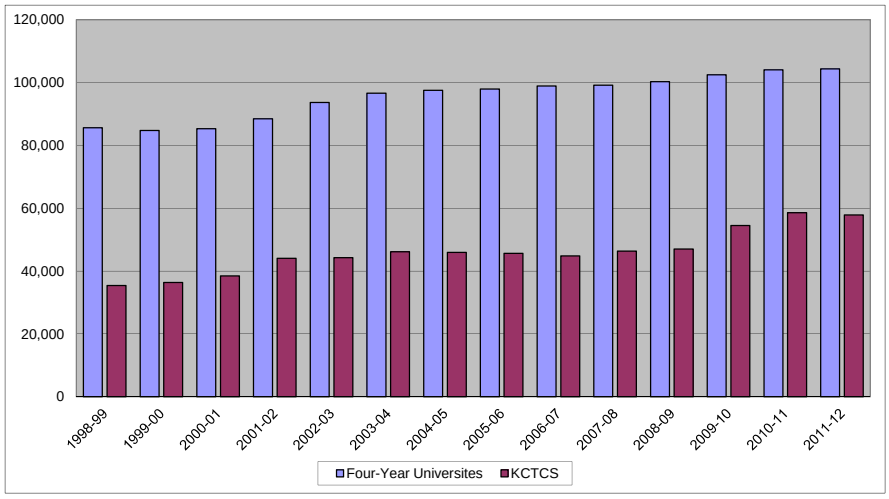
Tuition and Fees – Average Annual Amounts



Tuition and Fees – Annual Increases



Full-Time Equivalent Enrollment Fall of Each Year



Human Services Spending Growth – FY 1998-2014

- Total General Fund Spending Growth 58%
- Kentucky Personal Income Growth 94%

- Human Services Spending Growth 54%
  - Behavioral Health 51%
  - Adult and Child Protective Services (Community Based Services) 51%
  - Public Health 13%

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Spending Growth – FY 1998-2014

- Total General Fund Spending Growth 58%
- Kentucky Personal Income Growth 94%

- K-12 Education 61%
- Medicaid 140%
- Postsecondary Education 32%
- Justice System 93%
- Human Services 54%
- Debt Service 193%
- Rest of Government -8%

20

Budget Balancing Measures During Beshear Administration

	Fiscal Year	Description	Amount (millions)
1	2008	Budget Reduction	$ 76
2	2009	Enacted Reduction	$ 176
3		Mandated Budget Gap	$ 180
4		Budget Reduction	$ 147
5	2010	Budget Reduction - Round 1	$ 273
6		Budget Reduction - Round 2	$ 49
7	2011	Enacted Reduction	$ 61
8		Mandated Budget Gap	$ 131
9	2012	Enacted Reduction	$ 81
10		Mandated Budget Gap	$ 169
11	2013	Enacted Reduction	$ 140
12		Mandated Budget Gap	$ 40
13	2014	Enacted Reduction	$ 6
			$1.6 billion

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Budget Balancing Measures During Beshear Administration

	Fiscal Year	Description	Most Common % Cut
1	2008	Budget Reduction	3.0%
2	2009	Enacted Reduction	12.0%
3		Mandated Budget Gap	4.5%
4		Budget Reduction	4.0%
5	2010	Budget Reduction - Round 1	4.0%
6		Budget Reduction - Round 2	3.0%
7	2011	Enacted Reduction	3.5%
8		Mandated Budget Gap	1.5%
9	2012	Enacted Reduction	1.0%
10		Mandated Budget Gap	2.0%
11	2013	Enacted Reduction	8.4%
12		Mandated Budget Gap	TBD
13	2014	Enacted Reduction	NA
			38.4%

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Cumulative Impact of Cuts – Various Agencies

Finance Agencies	30-38%	KET	27%
Labor	38%	Education & Workforce	23-27%
Area Development Districts	28%	CHFS Non-Medicaid	7-28%
Public Protection	30-38%	K-12 Non-SEEK	27%
Constitutional Officers	32-36%	Natural Resources	15%
Military Affairs	34%	State Police	15%
Environmental Protection	32%	Universities	15%
Tourism, Arts & Heritage	30%	Juvenile Justice	13%
Economic Development	29%	Veterans' Affairs	6%

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Cost Containment Measures in Major Program Areas

- Medicaid
- Corrections
- Public Pensions
- Health Insurance

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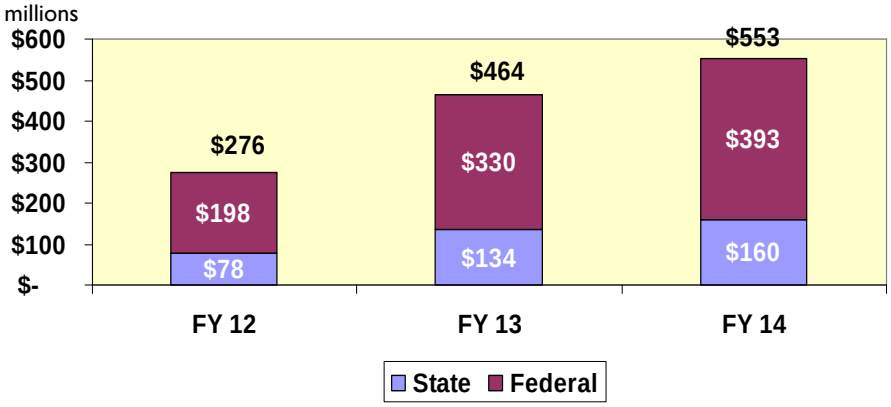
$1.3 Billion Total Managed Care Savings

Additional $294 million General Funds would be required for the 2012-14 biennium without managed care savings



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Justice System Spending Growth – FY 1998-2014

- Total General Fund Spending Growth 58%
- Kentucky Personal Income Growth 94%
- Justice System Spending Growth 93%
  - Judicial Branch 138%
  - Corrections 97%
  - Juvenile Justice 69%

26

Corrections – Recent Reforms

- **Task Force on Penal Code and Controlled Substances-Findings**
  - Prison population grew 45% 2000-2009 vs 13% All States
  - Cost of Corrections – 1998-2010 +86%
  - While crime rate was flat, adult arrests rose 32% from 2000-2009
  - Ky placed a higher % of offenders in prison vs. probation/alternatives
  - Parole Violators doubled as a % of prison admissions
  - Drug offenders as a % of prison admissions rose from 30 to 35%

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Corrections – Recent Reforms

- Enhance Public Safety and Control Costs
- Base key decisions on risk and needs assessment
- Improve supervision
- Modernize controlled substance laws-focus on high-level offenders, alternatives for non-violent offenders
- Reinvest in substance abuse treatment and programs to reduce recidivism
- Reduce sentences for low-level crimes
- Require community supervision upon release-last 6 months of sentence
- Save up to $420 million over 10 years

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Public Pension Changes Made in 2008
Changes to KERS Non-Hazardous for New Hires

- **Increased Employee Contribution -** from 5% TO 6% (1% to health insurance)
- **Decreased Benefit Factor -** from 1.97% TO a range of 1.10%-1.75% for up to 30 years
- **Lengthened Time to Full Retirement -** from 27 years of service at any age TO a Rule of 87: age + service must equal 87 and at least 57 years of age
- **Decreased Final Compensation Calculation -** from average of highest 5 years of salary including lump sum compensatory time payment TO just average of last 5 final years
- **Decreased Health Insurance –** major reduction in 2003. In 2008, Rule of 87 needed to be eligible, adjusted annually by 1.5%. Retained $10 per month benefit for each year of service.
- **Decreased Cost of Living Adjustment (COLA) –** from discretionary increase based on CPI-capped at 5% TO discretionary increase of 1.5%.

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Retirement Costs - General Fund (in millions$)

	School Employees	State Employees	Total	Share of General Fund
FY 2009	$530.6	$97.7	**$628.3**	7.0%
FY 2010	$563.9	$108.9	**$672.8**	8.1%
FY 2011	$569.4	$122.4	**$691.8**	8.0%
FY 2012	$585.7	$133.8	**$719.5**	7.7%
FY 2013	$591.7	$155.6	**$747.3**	7.9%
FY 2014	$646.7	$173.8	**$820.5**	8.4%

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Employer Contribution Rate Non-Hazardous Employees

FY 2007-08 Rate	8.50%
FY 2008-09 Rate	10.01%
FY 2009-10 Rate	11.61%
FY 2010-11 Rate - 44% of Required Contribution	16.98%
FY 2011-12 Rate - 48% of Required Contribution	19.82%
FY 2012-13 Rate - 53% of Required Contribution	23.61%
FY 2013-14 Rate - 57% of Required Contribution	26.79%
FY 2014-15 Rate - 61% of Required Contribution	29.28%
FY 2015-16 Rate - 65% of Required Contribution	31.59%
FY 2016-17 Rate - 69% of Required Contribution	33.74%
FY 2017-18 Rate - 73% of Required Contribution	35.48%
FY 2024-25 Rate - 100% of Required Contribution	48.30%

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Health Insurance-Employer Costs General Fund

	Millions $	% Change	Medical Care Inflation %
FY 2007	$588.2	-1.2%	4.0%
FY 2008	$627.2	6.6%	4.6%
FY 2009	$625.7	-0.2%	3.0%
FY 2010	$712.7	13.9%	3.5%
FY 2011	$747.3	4.9%	3.1%
FY 2012	$741.0	-0.9%	3.4%
FY 2013 Budgeted	$755.4	2.0%	
FY 2014 Budgeted	$770.5	2.0%	

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Salary Increment Policy for State Employees 1998-2014

Fiscal Year	State Employee Raises	Inflation
FY 1998	5%	1.8%
FY 1999	5%	1.7%
FY 2000	5%	2.9%
FY 2001	5%	3.4%
FY 2002	5%	1.8%
FY 2003	2.7%	2.2%
FY 2004	$1,080	2.2%
FY 2005	2% + 1% on Jan 1,2005	3.0%
FY 2006	3%	3.8%
FY 2007	$1,200 on average	2.6%
FY 2008	$1,200 on average	3.7%
FY 2009	1%	1.4%
FY 2010	1%	1.0%
FY 2011	-2.3% due to 6 furlough days	2.0%
FY 2012	0%	2.9%
FY 2013	0%	1.3%
FY 2014	0%	1.9%
FY03-FY14	17.3%	30.0%
FY08-FY14	2.0%	11.8%

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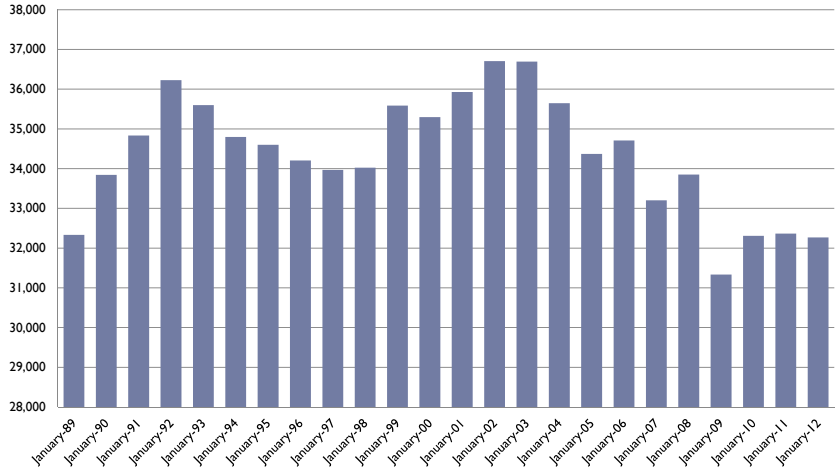
Kentucky State Government – Number of Full Time Employees 1989-2012



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Impacts of Recent Cuts

- **Economic Development**
  - Kentucky's economic development offices in Brussels and Santiago have been closed, reducing the Commonwealth's outreach to potential investors and global trading partners.
  - Investment in Commercialization, Innovation, and Science and Technology programs has been reduced by almost half.
- **Energy and Environment Cabinet**
  - Department for Environmental Protection has seen an increase in backlogs for water permits.
  - Lack of enforcement/inspection staff has resulted in delayed or no enforcement actions regarding wastewater discharge of the Clean Water Act .

35

Impacts of Recent Cuts

- **Children's Services**
  - The elimination of Diversion services in Community Based Services resulted in about 100 additional children entering the foster care system instead of receiving intensive services and remaining in the family home.
- **Aging Programs**
  - Aging programs had a loss of services for 140 clients, such as Meals on Wheels which served 279,532 fewer meals from FY 2008 to FY 2010.
- **Local Health Departments**
  - Reduced funding for Local Health Departments has resulted in fewer women receiving prenatal care, fewer children receiving immunizations, and fewer Kentuckians with diabetes receiving comprehensive care.
- **Community Mental Health Services**
  - No increase from the General Fund since 1998. Medicaid reimbursement rates have been frozen since 2001.

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Impacts of Recent Cuts

- **Rehabilitation to Work for Persons with Disabilities**
  - Reduced General Fund has resulted in a loss of $11 million in matching Federal Funds – 8,900 fewer persons served.
- **Tourism and Parks**
  - Reduced hours of operation .
- **Aid to Localities**
  - Reductions impact local governments: libraries, jails, public transportation, area development districts.
- **Maintenance of Physical Plant**
  - Operating budget cuts reduce funding for preventive maintenance.

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US vs. Ky Real Personal Income Growth Post-Recession Periods

	1983-1990	2001-2008	2009-2012 Q2
United States	28.6%	19.0%	7.4%
Kentucky	22.4%	15.1%	6.9%
Difference	-6.2%	-3.9%	-0.5%

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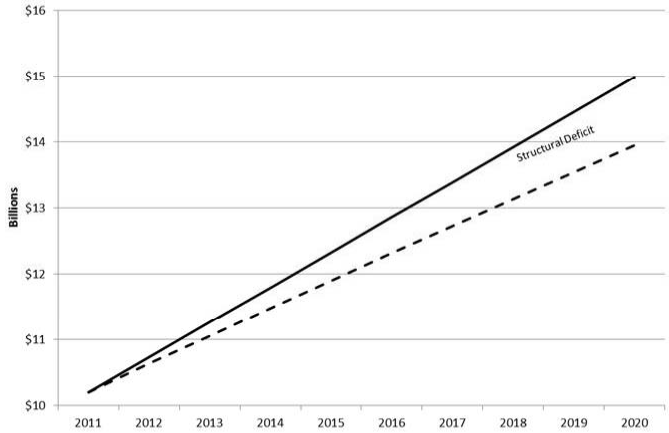
Adequacy & Elasticity: Simulated Kentucky Revenue



Source: Authors' calculations

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1

What Does the Future Hold?

- Budget Challenges
  - Demand for government services goes up when the economy is down
  - Adequately fund pension obligations
  - Address infrastructure needs – especially in education
  - Address the under investment in education
  - Pent up demand in many areas of government
  - Need to increase the Rainy Day Fund
  - Healthcare and justice system costs continue to increase faster than revenues
  - Aging population will require additional services

40

What Are the Options?

- Stay on the same path
  - Continue to cut spending
  - Continue efforts to reduce increasing costs in Medicaid, Corrections, Pensions, Health care
  - Continue efforts to increase government efficiency
- Make systemic changes to the revenue generating structure
- Combination of these strategies

Questions?

September 13, 2012

Dear Lt. Governor Abramson and Members of the KY Blue Ribbon Tax Commission:

On behalf of the Kentucky Press Association, the Kentucky Broadcasters Association and other groups listed below we would like to voice our concerns about a possible sales tax on advertising. While we fully support the diligent work of the Tax Commission and support tax reform in Kentucky we want to draw a clear distinction regarding a tax on advertising. An advertising tax is a tax on businesses and not a tax on consumers. During this tough economic recession an additional tax on businesses would cripple Kentucky small businesses.

A tax on advertising services or placement increases the cost of advertising. Additionally an ad tax is a tax on businesses that would be past on to each consumer. Because most clients and consumers operate on a fixed advertising budget, they will compensate for the tax by decreasing their advertising purchases. This will have a direct—and negative—impact on the advertising industry, economy and state revenues. Advertising is the engine that fuels the economy. Less advertising means fewer sales. Fewer sales mean reduced revenue and fewer jobs. Fewer sales also result in less sales tax revenue for the state. Advertising is a legitimate cost of doing business and not the type of end-use consumption targeted by sales taxes.

Proponents argue that since services are a growing part of the economy, they should be subject to the sales tax. They often do not recognize the distinction between different kinds of services or between business and consumer services.

Since Florida, passed and repealed an advertising and services tax in 1987, well over half the states, including Kentucky in 1990, have considered, and rejected, a tax on advertising. The most recent proposal was in Pennsylvania, where an advertising and services tax was passed in the Pennsylvania House of Representatives as an amendment to a bill addressing medical savings accounts but was stopped by the Senate after a hearing on the matter.

Please consider how a sales tax on advertising would create an additional hardship on Kentucky businesses.

Respectfully,

Kentucky Press Association, David Thompson
Kentucky Broadcasters Association, Gary White
The Lexington Chapter of the American Advertising Federation
The Louisville Chapter of the American Advertising Federation

Lexington Herald Leader
Dawson Springs Progress, Scott Dillingham

September 13, 2012

Dear Lt. Governor Abramson and Members of the KY Blue Ribbon Tax Commission:

The below listed limestone quarries want to encourage the Commission to strike down any proposal that would impose a tariff on stone that is mined outside of Kentucky and brought into this state.

A tax or tariff on out of state shipments of essentially anything (including stone) is a violation of the Equal Protection Clause of the US Constitution. A tax on out of state shipment of goods into a state would impede interstate commerce and therefore would be illegal according to our Constitution.

An out of state producer of stone already deals with and pays the following that an in state producer does not:

1. Transportation/shipping costs to bring the stone across state lines
2. Potential toll roads on our bridges coming into KY
3. Rising cost of diesel and maintenance on equipment to ship the stone into KY.

After adding all of the costs above, in state producers have a cost advantage even though they pay a severance tax to KY counties.

Several out of state producers sell limestone to KY Utilities. If they were forced to pay an additional tax on top of the costs listed above the ratepayers would pay a higher utility rate as a result.

In state coal producers and in state limestone producers pay a very important severance tax to the counties in which stone and coal are severed. However, out of state coal producers DO NOT pay a similar tax to ship their coal into KY so why should out of state stone producers be burdened with such a tax?

Considering the massive bridges project that is slated to begin in the upcoming years the state should take into consideration the cost of the stone they will be purchasing and how a change in the tax structure would impact that cost to the state.

We would respectfully ask members of this Commission to strongly consider the ramifications of imposing a tax on out of state shipments of stone into the state of Kentucky.

Respectfully,

Corydon Stone & Asphalt, Richard L. Cripe
Sellersburg Stone, Richard L. Cripe
Hanson Aggregates, Craig Morgan
Mulzer Crushed Stone, Inc. Jeff Mulzer
Indiana Mineral Aggregates Association, Robert Jones

SELLERSBURG
STONE COMPANY, INC.
CRUSHED LIMESTONE & ASPHALT PRODUCTS
Since 1947

Sellersburg Stone Company, Inc.

Correspondence:
P.O. Box D
Sellersburg, Indiana
47172

Quarry Location:
1019 East Utica Street
Sellersburg, Indiana

Phone (812) 246-3383
FAX (812) 246-7349

September 7, 2012

Dear Lt. Governor Abramson and Members of the KY Blue Ribbon Tax Commission:

We are an Indiana limestone quarry which sells and delivers aggregates to buyers in Kentucky. We are writing to encourage the Commission to strike down any proposal that would impose a tariff on stone that is severed outside of Kentucky and brought into this state.

A tax or tariff on out of state shipments of essentially anything (including stone) is a violation of the United States Constitution. If enacted, it would be challenged and ultimately adjudicated to be unenforceable.

Furthermore, an out of state producer of stone inherently faces expenses, as described below, which are not incurred to the same degree by an in-state producer:

1. Transportation/shipping costs to bring the stone across state lines;
2. Potential toll roads on the Louisville area bridges coming into Kentucky; and
3. Rising cost of diesel fuel and maintenance on equipment to ship the stone into Kentucky.

After considering all of the costs above, in-state producers maintain a competitive advantage even though they pay a severance tax to Kentucky counties.

Several out of state producers sell limestone to Kentucky utility companies. If they were forced to pay an additional tax on top of the costs listed above the ratepayers would pay a higher utility rate as a result.

In-state coal producers and in-state limestone producers pay a very important severance tax to the counties in which stone and coal are severed. However, out of state coal producers DO NOT pay a similar tax to ship their coal into Kentucky. So, why should out of state stone producers be burdened with such a tax?

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We would respectfully ask members of this Commission to strongly consider the ramifications of imposing a tax on out of state shipments of stone into the state of Kentucky. Once again, we believe it would be ruled unconstitutional.

Respectfully,

Richard L. Cripe

Richard L. Cripe
President/CFO
Sellersburg Stone Company, Inc.

CORYDON STONE & ASPHALT, INC.
1100 QUARRY ROAD NW
CORYDON, IN 47112
PHONE (812) 738-2216
FAX (812) 738-8400

SINCE 1926

September 7, 2012

Dear Lt. Governor Abramson and Members of the KY Blue Ribbon Tax Commission:

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Respectfully,

Richard L. Cripe
President/CFO
Corydon Stone & Asphalt, Inc.

CABINET FOR ECONOMIC DEVELOPMENT

Steven L. Beshear
Governor

Old Capitol Annex
300 West Broadway
Frankfort, Kentucky 40601
ThinkKentucky.com

Larry M. Hayes
Secretary

August 24, 2012

Lieutenant Governor Jerry Abramson
Lt. Governor's Office
Blue Ribbon Commission on Tax Reform
700 Capitol Avenue
Frankfort, KY 40601

Re: Barrel Tax

Dear Lt. Governor Abramson,

The Cabinet for Economic Development completed its state-wide strategic planning process earlier this year. The first step of the process was a general SWOT analysis to determine what industries are strong or have the potential to grow. Additionally, third party consultants took suggestions from more than 2,000 Kentucky companies and individuals as to how Kentucky can move its economy forward. In the end certain target industries were identified and various actions recommended to grow those industries.
The strategic plan consultants, Boyette Strategic Advisors (BSA), identified Value Added Agriculture and Beverage Products as one of Kentucky's target industries and further stated that recent reports indicate the beverage industry is rebounding from the economic downtown.

> According to 2010 economic data released by the Distilled Spirits Council of the United States, supplier volumes rose 2 percent to 190 million cases and revenue rose 2.3 percent to $19.1 billion in 2010. Whiskey showed strong growth, particularly in the super premium segment, which increased by 8.1 percent overall to over $1.1 billion. The distilled spirits industry's annual growth rate is predicted to accelerate to 3.9 percent growth over the five years to 2015.

BSA also included as one of Kentucky's action items a recommendation to "consider repealing or phasing out the remaining property tax on business Inventory" or "consider some type of credit against the inventory tax to support the existing distillery industry in the state".

This is consistent with statements made by Beam Global and Buffalo Trace Distilleries in legislative hearings over the past few legislative sessions. They point out that companies producing alcohol that improves with age will be charged on the value of the product being stored in barrels at the distillery facilities. The aging of the product is part of the process of making the quality product on which these distilleries pride themselves. These distilleries claim that 60% of their product cost is tax. The industry has offered to accept tax credits on this tax to be reinvested in Kentucky as opposed to total and absolute relief so that their cost savings benefit the economy.

The Kentucky Economic Development Partnership Board adopted Kentucky's Unbridled Future, the state-wide strategic plan, at its meeting on January 25, 2012, so I write to you today only to make you aware of the study findings and recommendations. The tax issues faced by this industry may impede its growth here. Of course, any loss of revenue due to a tax reduction is very difficult for the state at this time and the Commission as well as the legislature must weigh many more complicated factors in the larger context of total tax revenues before determining the appropriate action to be taken on this issue. We appreciate the hard work of the Commission and we look forward to their final product.

Sincerely,

Holland B. Spade
Chief of Staff

kpma
Kentucky Petroleum Marketers Association

REPRESENTING KENTUCKY'S FUEL INDUSTRY SINCE 1926

11/29/12

Lt. Governor Jerry Abramson
Chairman
Blue Ribbon Commission on Tax Reform
Frankfort, KY 40601

Lt. Governor Abramson,

On behalf of the Kentucky Petroleum Marketers Association, I'd like to commend the work done thus far by the Governor's Blue Ribbon Commission on Tax Reform. As a trade association, representing 134 small businesses and their thousands of employees, it has been very helpful to follow the work of the Commission and the various reports and comments made by stakeholders and the consultants.

As we have been following the progress, it has come to my attention that on several occasions, including in a presentation from the Department of Revenue that contained recommendations, changes to the Road Fund have been suggested. KPMA members remit the motor fuels tax to the Department of Revenue. As such, it is very important that KPMA be engaged in discussions involving any of the road fund issues involving the motor fuels taxes.

One of the recommendations that have been preliminarily approved by the Task Force is to reduce the 2.25% compensation provided the gasoline dealer under KRS 138.270 to 1%. This compensation is to cover evaporation, shrinkage, collection costs, bad debts, and handling and reporting the tax. The allowance has been in place since 1951 and is built into virtually every gasoline dealer's business plans and revenue base.

It was our understanding that the Commission was not charged with reviewing the gas tax or developing recommendations to address any changes to the Road Fund. We understand the consultants also have stated that the Road Fund deserves its own review and they did not have the time nor charge to consider it, along with the General Fund.

As the work of the Commission continues, if you do intend for the road fund to be included, KPMA requests the opportunity to comment on recommendations that have been discussed thus far. We hope that changes involving the Road Fund will be fully vetted and, like the consultants, believe it deserves a review all on its own.

Sincerely,

Brian P. Clark

Brian Clark
Executive Director
Kentucky Petroleum Marketers Association

Cc: Katie Dailinger
Ashley Parrott

2365 Harrodsburg Road Suite A325 | Lexington, Ky 40504 | Phone: (859) 226-4374
Fax: (859) 226-4404 | www.kpma.net

INSTITUTE ON TAXATION AND ECONOMIC POLICY

Policy Brief

Informing the debate over tax policy nationwide

August 2012

Response to Observations from the Kentucky Chamber of Commerce about ITEP's Kentucky "Who Pays" Distributional Analysis

In August 2012 the Kentucky Chamber of Commerce issued a brief[1] offering a variety of observations that policymakers and the public should "consider" when interpreting the Kentucky results from the Institute on Taxation and Economic Policy's (ITEP) *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* report.[2] Most of these observations explain more simply the basic findings of the *Who Pays* report, but the Chamber does raise several questions about ITEP's methodology. This short brief responds to those questions.

Clarifications: Occupational Taxes and Federal Tax Benefits

The Chamber's brief offers two incorrect critiques of the *Who Pays* results. First, the Chamber asserts that the *Who Pays* report "does not consider local occupational taxes." This is incorrect. ITEP's results do take into account the occupational taxes levied in Kentucky. The impact of the occupational tax is shown in the income tax portion of the study's findings. Secondly, the Chamber warns that our calculations "appear to overstate the federal tax benefit to those in the higher income categories in light of the federal Alternative Minimum Tax and other statutory limits on itemized deductions." The federal tax benefit calculations do, in fact, take account of the federal Alternative Minimum Tax and other limits on itemized deductions. The "federal offset" would be substantially higher absent these limitations.

Response to Other Points Raised by the Chamber

#2: The ITEP analysis considers non-elderly taxpayers. In Kentucky, elderly taxpayers benefit from the exemption of retirement income up to $41,110 per person. In addition, Social Security benefits that may be taxed by the IRS and other states are totally exempt. They also typically do not pay local occupational taxes.

Like previous editions of our *Who Pays* analysis released over the past two decades, ITEP's latest tax incidence report focuses only on non-elderly taxpayers. We do this because tax systems often treat elderly families very differently from other families. Including elderly families would skew the study's portrayal of taxes on non-elderly families since virtually every state provides special tax treatment to senior citizens through the income and property tax.

#5: Sales taxes can be very regressive. Kentucky mitigates the otherwise regressive nature of sales taxes by exempting grocery items, residential utilities, prescription medicines and devices, and other items. The report acknowledges only grocery food as being exempt.

ITEP's sophisticated microsimulation computer model is capable of measuring the impact of virtually all the sales tax breaks provided under state laws, and we model the many tax breaks allowed by Kentucky's sales tax law. Although the text of our report focuses on state sales tax treatment of groceries, the single most important sales tax base choice, all Kentucky exemptions are taken into consideration in ITEP's distributional analysis.

[1] http://policy.kychamber.com/uploads/sites/329/Who%20Pays%20820.pdf
[2] http://www.itep.org/wp2009/ky_whopays_factsheet.pdf

#12: The ITEP analysis counts the EITC as an offset to the regressive impact of taxes, but benefits provided by state and local governments, such as free Medicaid health insurance benefits and free public education, are not counted. In Kentucky over 800,000 of Kentucky's 4,200,000 citizens receive Medicaid benefits and there are 647,000 students in Kentucky's public schools.

The EITC is clearly a tax provision, and the *Who Pays* report is limited to measuring the impact of tax provisions. The EITC is a tax credit designed specifically to offset the impact of regressive taxes. Measuring the distributional impact of spending-side provisions is difficult at best (are the beneficiaries of education spending just those families with kids, or do they include any employer hiring a product of Kentucky schools?). For example, Kentucky spent $2.5 billion on highway spending in FY 2008. How can the benefits of that spending easily be allocated among individuals and businesses? The same problems hold for police, fire, judicial and a host of other areas. Put another way, for every spending program for which there is an identifiable beneficiary, there are other spending programs for which the beneficiaries are harder to identify—and the spending programs with identifiable beneficiaries tend to be those that benefit low-income populations.

#13: Five states on ITEP's most regressive list are states that Kentucky competes with for jobs and economic expansion (Tennessee, Florida, Illinois, Pennsylvania and Alabama). The ITEP report does not consider competiveness in the process of determining what it considers to be a "fair" tax system.

The *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* report is focused on tax incidence and the impact that the tax structure has on people of different income levels. The report is the only one of its kind that allows policymakers to understand their state's tax structures in a national context. The report does not attempt to delve into issues of competitiveness. We also don't measure a variety of other aspects of tax policy, for example: simplicity, neutrality, or sustainability.

Kentucky Council on Postsecondary Education

Steven L. Beshear
Governor

1024 Capital Center Drive, Suite 320
Frankfort, Kentucky 40601
Phone: 502-573-1555
Fax: 502-573-1535
http://www.cpe.ky.gov

Robert L. King
President

August 30, 2012

The Honorable Jerry Abramson
Lt. Governor, Commonwealth of Kentucky
and Chair of the Governor's Blue Ribbon Commission on Tax Reform
700 Capitol Avenue, Suite 142
Frankfort, KY 40601

Dear Chair Abramson and Members of the Commission:

Now that the public hearings' phase of the Commission's work has been completed and prior to the Commission finishing its study with Frankfort meetings in September, October, and November, I believe this is the appropriate time to make important information available to the Commission in my role as president of the Kentucky Council on Postsecondary Education.

One of the key passages from the *Kentucky Postsecondary Improvement Act of 1997* (HB 1) states that the General Assembly, on behalf of the people of the Commonwealth, declares that a goal to be achieved by the year 2020 is "a seamless integrated system of postsecondary education strategically planned and ADEQUATELY FUNDED (emphasis added) to enhance economic development and quality of life." Thus, HB 1 spoke directly to the issue of adequacy, one of the five goals of the Commission's work. In thinking about adequacy in the context of postsecondary education, it occurs to me you might be especially interested in examining this issue from at least two perspectives, i.e., graphs which, I think, portray in different ways what has occurred to postsecondary education General Fund support in the Commonwealth since 1999.

The first graph, "Net General Fund Appropriations and Gross Tuition Revenue per FTE Student," indicates that while the per FTE student inflation-adjusted "cost" of public higher education in Kentucky actually declined from 1999 to 2011 by $735, the "price", paid by students and families in the form of tuition, has increased by $3,343. Of course, the principal reason for this increase is that state General Fund support during this same period has been reduced by $4,078 per FTE. I might add, headcount enrollment has substantially increased during this same period, from 158,942 in 1999 to 235,833 in 2011, a 48 percent increase.

The second graph, "State Investment in Education is Losing Ground to Other State Expenditures," addresses the issue of state government's budget priorities and compares the "share of the pie" of Kentucky's General Fund enacted budget from 1999 to 2014. This display indicates in 1999

postsecondary education's share of the Commonwealth's total General Fund appropriations was 15 percent while fifteen years later in 2014 that share will have been reduced to 12 percent. If postsecondary education had simply retained its same share in 2014 that it received in 1999, we would have $230 million more in General Fund appropriations' support for higher education. Moreover, because of the substantial enrollment growth experienced since reform, had expenditures per FTE remained constant, our institutions would have $734 million more in state support.

Thus, the two graphics just described put into perspective for students, families, and state policy makers the challenge of the funding adequacy issue addressed both in HB 1 (1997) and in the charge of the Tax Reform Commission. The trends highlighted in the graphs, including the significant loss of state investment in higher education, unsustainable increases in tuition, and overall loss of education as a state budget priority are worrisome from a long-term, economic growth perspective. The evidence is clear that the single, best way to grow Kentucky's economy is by improving the quality of its workforce. Achieving this goal is impossible without strong and sustained support for public education at the P-12, community college, and university level.

In closing, I simply want to bring to the attention of the Commission, for inclusion in its members' briefing book, these data which I trust you will find useful.

If you have any questions about this or any other postsecondary education issue, please feel free to contact my office.

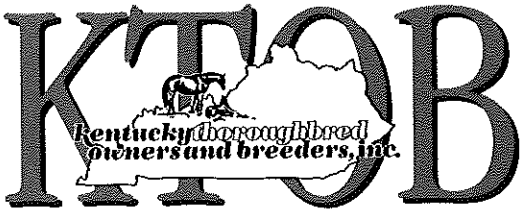
Sincerely,

Robert L. King
President

Attachments

c: Members, Council on Postsecondary Education
Presidents, Public Institutions

4079 Iron Works Parkway
Lexington, KY 40511-8483
(859) 259-1643
(800) 552-3781
Fax (859) 233-9737
Web Site: www.kta-ktob.com



6 September 2012

Honorable Jerry Abramson
Lt. Governor
700 Capitol Ave.
Frankfort, Ky. 40601

Attn: Ms. Ashley Parrott

Re: Governors Task Force on Tax Reform

Dear Lt. Governor Abramson,

On behalf of Kentucky's signature industry the Kentucky Thoroughbred Owners and Breeders would like to put forth some concerns of the equine industry, to the Task Force, as it relates to tax reform. We have two areas of concern, both of which impact the commercial breeding industry.

First: In most, if not all definitions of livestock, under KRS, the equine industry is included as being part of "production agriculture". However the commercial production of equine is subject to the state's 6% sales tax on feed, fencing, equipment and veterinarian medicines, while other farm species groups are exempt. Although we are not considered "food or fiber", we do produce a commercially viable product that goes to market and has a significant economic impact on the Commonwealth. We believe this tax to be an unfair expense. In addition, many of our producers raise cattle as a secondary crop, possibly creating a moral issue when purchasing feed, fencing the pastures, buying farm equipment and medicines. LRC has estimated the fiscal impact at $7 million.

Secondly: Enclosed you will find documents pertaining to the 6% sales tax that may or may not be leaved on the sale of yearlings and horses of racing age sold at auction or privately.

Yearlings: A non-resident is not subject to the 6% sales tax, whereas a resident, who most likely will keep the yearling in Kentucky, is subject to the tax. In addition this puts the resident at a distinct disadvantage since he/she will have to factor in the sales tax with respect to the amount they are willing to pay, whereas the non-resident does not.

Horses purchased as a racing prospect (two years old or older) are subject to the 6% sales tax unless they are shipped out of state immediately. This forces the purchaser to remove the animal from Kentucky where they could have stayed to be broken, raced, or to be cared for by our excellent veterinarians should a health issue arise. I enclose an article that specifically refers to such an instance. Furthermore, as an example of the impact of this impediment, in 2010 from sales conducted at Keeneland, 605 horses left the state, 72 stayed in Kentucky. The economic impact of a single horse leaving the state is in the tens of thousands of dollars

We appreciate the efforts of the task force and hope our issues will be addressed in the final outcome.

Respectfully submitted,

David L. Switzer
Executive Director

Sunny Despite the Rain...

It was cold and grey in Lexington Tuesday, but the sale of Funny Sunny energized the Keeneland sale pavilion. Bred by Highclere in Kentucky, Funny Sunny was hammered down to WinStar Farm for $60,000 at the Fasig-Tipton Calder Sale earlier in the year after breezing a quarter in :21 4/5. The filly's sire, Sharp Humor, stands at WinStar. Sent to trainer Richard Budge, Funny Sunny debuted going six furlongs at Hoosier Park Oct. 13 and made a favorable impression, rallying clear to a 2 1/4-length decision.

Chris Brothers
facebook.com

"Her first race was very impressive," said Chris Brothers. "She ran away from the field, and that's what you want to see first time out."

Added Pope, "She was on the outside and got hung wide around the turn, and had no clue what she was doing, but then figured it out and said, 'Oh, I'm supposed to be a *racehorse*.' And she just took off and passed them."

At WinStar's inaugural under-tack showcase Nov. 2, Funny Sunny breezed four furlongs in :48 4/5 (3:40 mark of video).

Pope laughed that Kentucky's tax laws played the deciding factor in where Funny Sunny will now go. "We thought about sending her to Churchill Downs, but after realizing I'd have to pay six-percent sales tax [if she stayed in Kentucky], we'll send her to Florida and probably have her ready to run at Gulfstream," she said.

Pope got into breeding and racing in the early 1980s, but has stepped up her involvement markedly in recent years. She's been active at the yearling and bloodstock sales, typically for nicely bred fillies and mares, but this year expanded the scope of Whisper Hill, buying some yearling colts to pinhook. *Cont. p5*

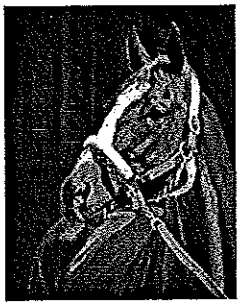
JRA photo

Click here for a replay of Snow Fairy (Ire) (Intikhab)'s win in last Sunday's G1 Queen Elizabeth II Commemorative Cup at Kyoto

Stud News Cont. from p3

SUMMER BIRD TO STAND FOR $15,000

Champion Summer Bird (Birdstone--Hong Kong Squall, by Summer Squall), hero of the 2009 GI Belmont S., GI Shadwell Travers S., and GI Jockey Club Gold Cup S., will stand his first season at stud for $15,000 at Mr. and Mrs. Ben P. Walden Jr's Pauls Mill in 2011, it was announced Tuesday. "Our mission at Pauls Mill is to shower breeders with stud fee value and personal attention," Walden commented. "To that end our 2011 fees speak for themselves, but Summer Bird's introductory fee breaks all the rules."



Equi-Photo

Sales Tax Regulations and Exemption Procedures

Kentucky Sales Tax is 6%.

Exemption For Breeding Stock
The purchase of broodmares and stallions is exempt from Kentucky sales tax. The purchase is for breeding purposes only. (Initial line 1 on Acknowledgement of Purchase and Security Agreement.)

Exemption For Horses Less Than Two Years of Age
The purchase of weanlings or yearlings by persons, who are not residents of Kentucky and who intend to transport the horses out of Kentucky immediately after the sale or after a temporary stay in Kentucky for training, may qualify for exemption of the tax. (Initial line 2 on Acknowledgement of Purchase and Security Agreement.)

Exemption For Horses in Interstate Commerce
Horses not qualified for exemptions as breeding stock or as horses under two years of age as stated above are referred to as "Racing Prospects" and may be exempt if sold/purchased in interstate commerce. Purchases may qualify for the interstate commerce exemption if the horses purchased will be immediately shipped by Keeneland Association, Inc. from Lexington, Kentucky to the purchaser at an out-of-state point via licensed Interstate Common Carrier (ICC). Keeneland will issue a release to the ICC carrier upon receipt of the Bill of Lading. The shipment shall be wholly at purchaser's risk. All expenses incurred by Keeneland Association in shipping the horses will be invoiced to the purchaser and Keeneland shall retain a lien on the horse to secure all such expenses. (Initial line 3 on Acknowledgement of Purchase and Security Agreement).

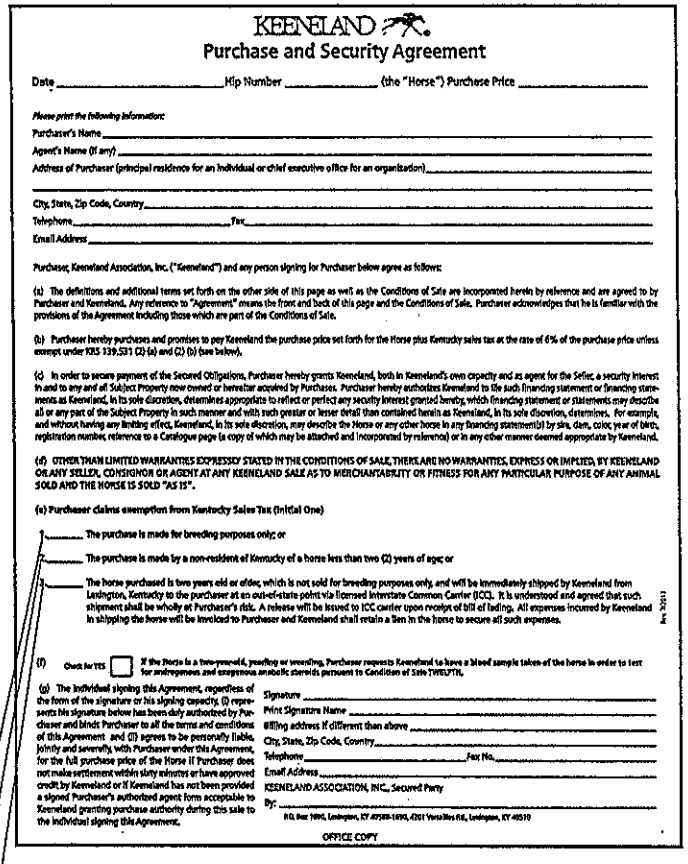
Exemption For Resale
The horse is being purchased for resale as evidenced by execution of a Resale Certificate form provided by the Kentucky Revenue Cabinet. **Taxpayer must provide a valid executed Kentucky Sales and Use Tax Certificate to Keeneland's Sales Accounting Office in order to be eligible for this exemption.**

No Exemption
The sale/purchase of all other horses not described above are subject to Kentucky Sales Tax at 6%.

Entitlement to exemption must be indicated by the purchaser's initials on the Acknowledgement of Purchase and Security Agreement contemporaneously with purchase and before delivery of stock is made.

If the exemption is disallowed for any reason, purchaser shall be responsible for any sales tax due, including interest and penalties, and shall indemnify Keeneland therefore.

Sales Tax Regulations and Exemption Procedures



KEENELAND

Purchase and Security Agreement

Date _____ Hip Number _____ (the "Horse") Purchase Price _____

Please print the following information:

Purchaser's Name _____

Agent's Name (if any) _____

Address of Purchaser (principal residence for an individual or chief executive office for an organization) _____

City, State, Zip Code, Country _____

Telephone _____ Fax _____

Email Address _____

Purchaser, Keeneland Association, Inc. ("Keeneland") and any person signing for Purchaser below agree as follows:

(a) The definitions and additional terms set forth on the other side of this page as well as the Conditions of Sale are incorporated herein by reference and are agreed to by Purchaser and Keeneland. Any reference to "Agreement" means the front and back of this page and the Conditions of Sale. Purchaser acknowledges that he is familiar with the provisions of the Agreement including those which are part of the Conditions of Sale.

(b) Purchaser hereby purchases and promises to pay Keeneland the purchase price set forth for the Horse plus Kentucky sales tax at the rate of 6% of the purchase price unless exempt under KRS 139.531 (2)-(a) and (2) (b) (see below).

(c) In order to secure payment of the Secured Obligations, Purchaser hereby grants Keeneland, both in Keeneland's own capacity and as agent for the Seller, a security interest in and to any and all Subject Property now owned or hereafter acquired by Purchaser. Purchaser hereby authorizes Keeneland to file such financing statement or financing statements as Keeneland, in its sole discretion, determines appropriate to reflect or perfect any security interest granted hereby, which financing statement or statements may describe all or any part of the Subject Property in such manner and with such greater or lesser detail than contained herein as Keeneland, in its sole discretion, determines. For example, and without having any limiting effect, Keeneland, in its sole discretion, may describe the Horse or any other horse in any financing statement(s) by sire, dam, color, year of birth, registration number, reference to a Catalogue page (a copy of which may be attached and incorporated by reference) or in any other manner deemed appropriate by Keeneland.

(d) OTHER THAN LIMITED WARRANTIES EXPRESSLY STATED IN THE CONDITIONS OF SALE, THERE ARE NO WARRANTIES, EXPRESS OR IMPLIED, BY KEENELAND OR ANY SELLER, CONSIGNOR OR AGENT AT ANY KEENELAND SALE AS TO MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY ANIMAL SOLD AND THE HORSE IS SOLD "AS IS".

(e) Purchaser claims exemption from Kentucky Sales Tax (Initial One)

1) _____ The purchase is made for breeding purposes only; or

2) _____ The purchase is made by a non-resident of Kentucky of a horse less than two (2) years of age; or

3) _____ The horse purchased is two years old or older, which is not sold for breeding purposes only, and will be immediately shipped by Keeneland from Lexington, Kentucky to the purchaser at an out-of-state point via licensed Interstate Common Carrier (ICC). It is understood and agreed that such shipment shall be wholly at Purchaser's risk. A release will be issued to ICC carrier upon receipt of bill of lading. All expenses incurred by Keeneland in shipping the horse will be invoiced to Purchaser and Keeneland shall retain a lien in the horse to secure all such expenses.

Rev. 7/2011

(f) Check for YES ☐ If the Horse is a two-year-old, yearling or weanling, Purchaser requests Keeneland to have a blood sample taken of the horse in order to test for endogenous and exogenous anabolic steroids pursuant to Condition of Sale TWELFTH.

(g) The individual signing this Agreement, regardless of the form of the signature or his signing capacity, (i) represents his signature below has been duly authorized by Purchaser and binds Purchaser to all the terms and conditions of this Agreement and (ii) agrees to be personally liable, jointly and severally, with Purchaser under this Agreement, for the full purchase price of the Horse if Purchaser does not make settlement within sixty minutes or have approved credit by Keeneland or if Keeneland has not been provided a signed Purchaser's authorized agent form acceptable to Keeneland granting purchase authority during this sale to the individual signing this Agreement.

Signature _____

Print Signature Name _____

Billing address if different than above _____

City, State, Zip Code, Country _____

Telephone _____ Fax No. _____

Email Address _____

KEENELAND ASSOCIATION, INC., Secured Party

By: _____

P.O. Box 1690, Lexington, KY 40588-1690, 4201 Versailles Rd., Lexington, KY 40510

OFFICE COPY

1) If the horse was purchased for **Breeding Stock only,** initial line one. The purchase is exempt from sales tax.

2) If you are **not a Kentucky resident** and the horse is less than two years of age, initial line two. The purchase is exempt from sales tax.

3) If the horse purchased is a Racing Prospect (two years old or older and is not being sold for breeding purposes only), and will be immediately leaving Kentucky via licensed ICC carrier, then initial line three. You must provide Keeneland with the Bill of Lading indicating that the horse was shipped from Keeneland via a licensed ICC carrier to an out-of-state point. The purchase is exempt from sales tax.

Rev. 7/2011

Ernst & Young LLP
Suite 2400
400 West Market Street
Louisville, KY 40202

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To the Commissioners of the Governor's Blue Ribbon Commission on Tax Reform:

Over the past few months you have heard hours of testimony at the six public meetings in each of the state's congressional districts, as well as presentations from academics and the State Budget Director's Office. While the information presented to the Blue Ribbon Commission (the Commission) has been varied and broad ranging, we wanted to bring to the Commission's attention additional information that provides a larger, holistic context of tax reform in our Commonwealth from a business perspective. Specifically, how Kentucky's current state and local tax structures impact businesses both within and outside our state. A thriving, vibrant business community is critical to the success of any state. To this end, we are providing to the Commission a copy of two recent studies conducted by Ernst & Young and the Council on State Taxation (COST):

- Total state and local business taxes for fiscal year 2011 (July 2012); and
- Competitiveness of state and local business taxes on new investment (April 2011)

The first study mentioned above has been cited several times in public testimonies before the Commission, and we felt it necessary to provide the full report. While we have provided the studies to you in their entirety, we highlight in the pages that follow important points from each study that we believe are important to your deliberations.

If you have any questions regarding the materials we have presented to you, or if we can be of any further assistance to the Commission, please do not hesitate to reach out to us. Ernst & Young has been a productive member of the Kentucky business community since opening offices in Louisville in 1923. We care deeply about the success of our Commonwealth not only because we do business here but most importantly because our families live here. We appreciate your service to the Commonwealth of Kentucky and look forward to your recommendations on tax reform.

Sincerely,

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Total state and local business taxes for fiscal year 2011 (July 2012)

- As a national total for FY2011, local taxes paid by businesses approximated the amount of state taxes paid by business, $305.1 billion and $338.7 billion respectively. Accordingly, tax reform efforts need to consider both the state and local tax structures that currently exist within Kentucky.
- Property taxes account for 28.8% of business taxes in Kentucky compared to 38% nationally.
- Excise taxes, such as healthcare provider gross receipts taxes and motor fuels, account for 19.2% of business taxes in Kentucky compared to 12.6% nationally.

Competitiveness of state and local business taxes on new investment (April 2011)

- The key factor determining the impact of a state's business tax system on economic growth is the marginal effective tax rate on new business investment. In terms of a marginal effective tax rate[1], Kentucky is neither in the Top 10 or Bottom 10 of states based on the tax burden on new investment. In fact, Kentucky ranks 15th most competitive in terms of the tax climate for selected types of new business investment.
- The states with the most competitive business tax climates for new investment have combinations of the following:
    - Single sales factor apportionment formula with market based/destination sourcing for business income taxation;
    - A relatively low combined state and local effective sales tax rate on business purchases. Low statutory tax rates with substantial exclusions of business purchases from the tax base;
    - No personal property taxes and/or competitive tax rates for real business property;
    - Broad-based business entity taxation imposed on both pass-through entities and C-corporations;
    - Minimal taxation of foreign source income.

Kentucky business perspective

In closing, we would like to also share with the Commission thoughts and concerns that have been raised by the larger business community within Kentucky with respect to tax reform:

- Tax reform should have a long-term, phased-in perspective with a focus on increasing Kentucky's tax competitiveness and attracting and retaining a skilled workforce within Kentucky;
- Tax reform should be holistic considering not only the level of tax revenue but also the level of government expenditures and the overall cost of government;
- Tax reform should maintain and expand manufacturing in Kentucky as well as strengthen iconic industries within the Commonwealth;

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[1] In the EY/COST competitiveness study, the effective tax rate is the percentage change in the rate of return due to taxes. This is roughly equivalent to taxes divided by income with an adjustment for timing.

- Consider a local option sales tax in lieu of the current local occupational license taxes;
- A broad based sales tax on services and other business inputs will have a disproportionately negative impact on Kentucky head-quartered companies than out-of-state companies;
- Enact a single sales factor apportionment formula with market based/destination sourcing for corporate income tax with potential phase-in or elective status;
- Simplify the current corporate nexus consolidated return requirement and repeal the 50% loss limitation rule;
- Repeal the current property tax on inventories.

Total state and local business taxes

State-by-state estimates for fiscal year 2011

July 2012

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This study was prepared by the Quantitative Economics and Statistics (QUEST) practice of Ernst & Young LLP in conjunction with the Council On State Taxation (COST).

QUEST is a group of economists, statisticians and tax policy researchers within Ernst & Young LLP's National Tax Practice, located in Washington, DC. QUEST provides quantitative advisory services and products to private and public sector clients that enhance business processes, support regulatory compliance, analyze proposed policy issues and provide litigation support.

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and non-discriminatory state and local taxation of multijurisdictional business entities.

Executive summary

This study presents state-by-state estimates of the state and local taxes paid by businesses for fiscal year 2011. It is the 10th annual report prepared by Ernst & Young LLP in conjunction with the Council On State Taxation (COST).

Businesses paid $644 billion in state and local taxes in FY2011. Total state and local business taxes grew by 4.5%, reflecting a 9.8% increase in state business taxes and a 0.8% decrease in local business taxes. In FY2011, business taxes accounted for 45.9% of all state and local taxes. The level of tax collections in FY2011 reflects the positive impact of the economic recovery on businesses and corporate profits, increased production and prices of natural resources subject to state severance taxes, new and expanded taxes levied on health care providers at the state level, and the effects of higher unemployment insurance taxes resulting from continued high unemployment.

The state and local business tax estimates presented in this study reflect tax collections from July 2010 through June 2011 in most states. These include business property taxes, sales and excise taxes paid by businesses on their input purchases, gross receipts taxes, corporate income and franchise taxes, business and corporate license taxes, unemployment insurance taxes, individual income taxes paid by owners of non-corporate (pass-through) businesses, and other state and local taxes that are the statutory liability of business taxpayers.

This year's results reveal both significant lingering effects of the recession on business tax collections and significant variation in the level of state and local taxes paid by businesses across the states relative to economic activity.

Key findings of the study include:

- After falling by 0.8% in FY2009 and 0.6% in FY2010, state and local business taxes grew $27.9 billion (4.5%) in FY2011, with total state business taxes increasing by 9.8% and total local business taxes declining by 0.8%.
- Property taxes on business property decreased by an estimated 1.5% this year, totaling $244.9 billion in FY2011, or 38.0% of total state and local business taxes. Sales tax on business inputs and capital equipment totaled $129.7 billion, or 20.1% of business taxes, which is an increase of 5.2% from FY2010. The property tax and a significant portion of sales taxes paid by business are taxes on capital invested within a state.
- Although the corporate income tax has been the focus of significant debate in a number of state legislatures during recent years, FY2011 collections were $46.3 billion, only 7.2% of total state and local business taxes. Corporate income tax collections grew by 8.5% in FY2011. Individual income taxes on pass-through business income account for 5.6% of total state and local business taxes and grew by 10.0% in FY2011.

Total state and local business taxes in FY2011

Businesses paid $644 billion in total state and local taxes in FY2011, as presented in Table 1.[1] This section describes the business taxes in more detail and highlights the key results. The following taxes are included in business tax estimates to the extent each tax is determined to be the statutory liability of businesses and their owners:

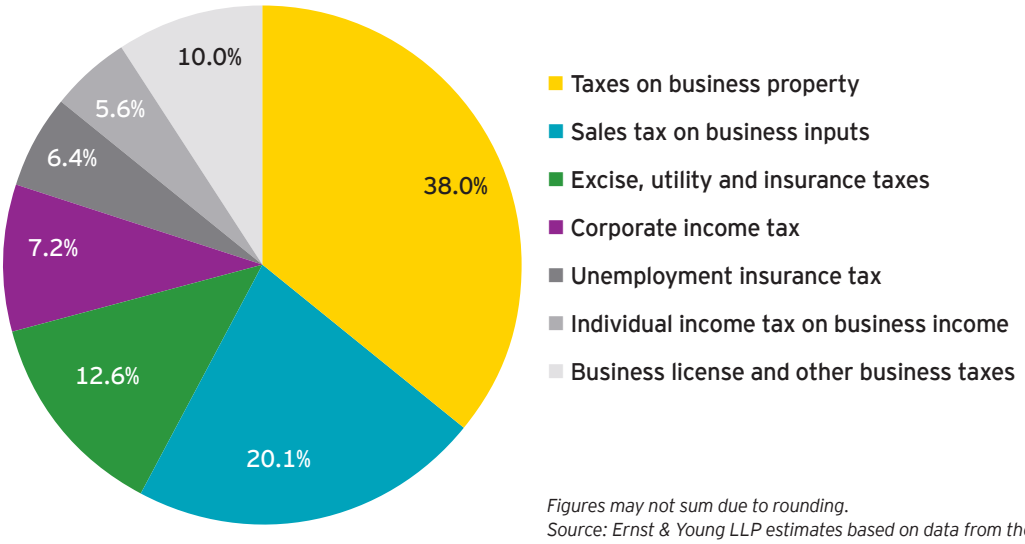
- As shown in Table 1 and Figure 1, property taxes on real, personal and utility property owned by businesses account for the largest share of total state and local business taxes, 38.0% or $244.9 billion. Note that the estimates do not include payments in lieu of taxes. Property taxes decreased 1.5% in FY2011, after growing 1.3% in FY2010 and 10.5% in FY2009. Typically, the local property tax is a stable source of tax revenue growth for local governments but decreased in FY2011 due to declining property values. Lags in property assessments and limitations on rate increases in some states may also result in low growth in FY2012 property taxes.
- Sales and use taxes paid by businesses on purchases of inputs, including capital equipment, totaled $129.7 billion, or 20.1% of all state and local business taxes. Sales and use taxes collected on sales to final consumers are excluded; only the taxes paid on businesses' operating inputs and capital equipment purchases are included in the total business tax estimates.[2]
- Corporate income tax collections were $46.3 billion in FY2011, an increase of 8.5% from FY2010. This increase in corporate income tax receipts in FY2011 follows a decrease of 8.5% in FY2010. Corporate income taxes accounted for 7.2% of total state and local business taxes in FY2011, up from 7.1% in FY2010. Through the first three quarters of FY2012, state corporate income taxes have declined approximately 2%. Note that FY2011 business taxes in Michigan, New Hampshire, Ohio, Texas and Washington that are not based on net income are not included in this category. These non-income business entity taxes totaled $10.7 billion in FY2011.
- Employer contributions to unemployment insurance (unemployment taxes) were $41.2 billion in FY2011, an increase of 27.1% ($8.8 billion). This increase accounts for nearly one-third of the overall increase in total state and local business taxes in FY2011. As discussed later in this report, state unemployment trust funds have been depleted by the recession, and states are facing large debts to the federal government for loans used to pay unemployment benefits. These large debts are due to the combination of underfunding during the last economic expansion and the severity of unemployment during the latest recession. States have responded to this fiscal pressure by increasing taxable wage bases and contribution rates, resulting in increased effective UI tax rates in 43 states since 2010.
- Excise taxes paid by business were an estimated $35.0 billion in FY2011. Excise taxes attributed to business include a portion of motor fuel taxes and other excise taxes, such as taxes on hotel and rental car expenditures by business, as well as health care provider taxes on the revenue of hospitals and other providers of health services. As described later in the report, health care provider taxes have grown rapidly over the past two years in response to increased state Medicaid funding pressures. Total estimated excise taxes, which include health care provider taxes, grew by 14.9% in FY2011. These estimates exclude excise taxes on tobacco, alcoholic beverages, amusements and pari-mutuels, which are allocated entirely to households.
- Business and corporate license taxes totaled $37.3 billion, including $27.2 billion of general business and occupation license taxes and $10.1 billion of motor vehicle taxes.
- Individual income taxes paid by owners of pass-through entities (e.g., partnerships, sole proprietorships, limited liability companies and S-corporations) totaled an estimated $36.3 billion in FY2011. Individual income taxes on pass-through business income were more than three quarters the size of corporate income taxes and represent 5.6% of total state and local business taxes.
- Taxes on insurance premiums and public utility gross receipts totaled $46.0 billion in FY2011, an increase of 1.1% due to increased insurance premium tax collections. These taxes are generally based on business gross receipts, and because they are generally levied in lieu of property or corporate income taxes, they are allocated solely to business.
- State severance taxes grew by 30.9% to $14.8 billion in FY2011. The increase in severance taxes was $3.5 billion, or 13% of the overall increase in state and local business taxes. Four states (Alaska, Texas, North Dakota and Wyoming) account for 80% of the increase in severance taxes due to increased production levels and commodity prices.
- Other business taxes totaled $12 billion, increasing 5.5% from the prior year.

Table 1. Total state and local business taxes – FY2010-FY2011 (US$billion)

Business tax	2011	2010	2011 % total taxes	One-year change
Property taxes on business property	$244.9	$248.6	38.0%	-1.5%
General sales taxes on business inputs	129.7	123.3	20.1%	5.2%
Corporate income tax	46.3	42.7	7.2%	8.5%
Unemployment insurance	41.2	32.4	6.4%	27.1%
Business and corporate license	37.3	37.0	5.8%	0.9%
Individual income tax on business income	36.3	33.0	5.6%	10.0%
Excise taxes	35.0	30.5	5.4%	14.9%
Public utility taxes	28.8	28.9	4.5%	-0.3%
Insurance premiums taxes	17.2	16.6	2.7%	3.6%
Severance taxes	14.8	11.3	2.3%	30.9%
Other business taxes	12.4	11.8	1.9%	5.5%
Total business taxes	**$643.9**	**$616.0**	**100.0%**	**4.5%**

Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Figure 1. Composition of total state and local business taxes – FY2011



Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Classifying business taxes

While corporate income taxes remain the most common business entity tax levied by states, many states have experimented with non-income business entity taxes based on a "pure" or modified gross receipts tax base. These taxes have been adopted by three states, Ohio, Michigan and Texas, since 2004, although Michigan repealed its Michigan Business Tax in 2011, effective January 2012. Two other states, Washington and New Hampshire, have levied gross receipts or value-added taxes for many years, and an increasing number of states levy minimum taxes based on gross receipts. As shown in Table 2, these taxes are classified as either corporate income or corporate license taxes in this study consistent with the U.S. Census Bureau classification. If each of these taxes were combined into a single gross-receipts-based business tax category, the collections would total $10.7 billion, equal to 23% of reported corporate income taxes reported in Table 1. Not shown in the table are minimum taxes based on gross receipts levied in several states as part of their corporate income tax system. For taxpayers subject to these taxes, the minimum taxes function as gross receipts taxes but are generally included in the corporate income tax statistics.

Table 2. Gross receipts and value-added based business entity taxes in FY2011 (US$billion)

Business tax	Census Bureau Tax Classification	FY2011	FY2010	One-year change
Michigan – Michigan Business Tax	Corporate income tax/general sales and gross receipts tax*	$2.1	$1.9	13.2%
New Hampshire – Business Enterprise Tax	Corporate income tax	0.2	0.2	-0.1%
Ohio – Commercial Activity Tax	Corporate license tax	1.4	1.3	9.7%
Texas – Texas Margin Tax	Corporate license tax	3.9	3.9	2.0%
Washington – Business and Occupation Tax	Sales tax	3.0	2.6	16.9%
Total gross receipts taxes		**$10.7**	**$9.8**	**9.0%**

Figures may not sum due to rounding.

**Michigan reports a lower amount to the Census Bureau. Michigan also splits the Michigan Business Tax into two pieces that are reported separately. The corporate income tax component reported by Michigan to Census for FY2011 was $0.7 billion and the remaining $1.2 billion is reported as sales tax.*

Source: Individual state tax collection reports.

State versus local business taxes in FY2011

Over the past three economic cycles, state revenue has declined during recessions while local revenue has grown, buoyed by the stability of the local property tax. During FY2011, that trend reversed and local revenues declined by 0.8%, led by a decline in local property tax revenues. Tables 2-A and 2-B provide dollar amounts, percentage distributions and growth rates in FY2011 for total business taxes at the state and local levels of government.

Total state and local business taxes increased by almost $28 billion in FY2011 after falling in FY2009 and FY2010. However, moderate growth in corporate income and sales taxes coupled with strong growth in other taxes such as severance, unemployment insurance, and health care provider taxes generated strong revenue gains at the state level while local tax collections declined.

At the state level, all types of business taxes increased in FY2011 with the exceptions of public utility taxes and business property taxes, resulting in overall state business tax growth of 9.8%. The overall growth in state business taxes was driven by strong growth in three tax categories: unemployment insurance taxes rose by 27.1%; state severance taxes on natural resource industries increased by 31%; and other selective sales taxes, which includes health care provider taxes, increased by 28%. To put this increase in revenue in perspective, state business taxes grew by an average of $20 billion or 9% per year, during the economic expansion from FY2002 to FY2007.

The 1.5% decline in local property taxes that occurred during FY2011 is a very unusual event. Data on property tax collections are available back to the 1940s and during that period, annual property tax collections have never declined until FY2011.[3] The decline in local property tax collections began in the third quarter of FY2010, but overall FY2010 property tax collections were still up overall compared with FY2009 due to growth in the first, second and fourth quarters of FY2010. Property tax revenue appears to be stable going in to FY2012, with reported collections that are on average less than 1% higher than during the same quarter in FY2011.

Tables 2-A and 2-B illustrate the significant difference in the composition of state and local business taxes. Table 2-A shows the percentage distribution of state taxes by tax type; Table 2-B shows the distribution for local business taxes. While sales taxes on business inputs account for a large share of total business taxes at the state level (29.9%), they account for a relatively small share of local taxes (8.9%). Property taxes are the largest local business tax (77.9% of the total), but a very minor share of state taxes (2.7%).

Table 2A. State business taxes – FY2011 (US$billion)

State business taxes	State business taxes FY2011	State business taxes FY2010	% total state business taxes	One-year growth, state business taxes
General sales taxes on business inputs	$101.2	$95.8	29.9%	5.7%
Unemployment insurance	$41.2	$32.4	12.2%	27.1%
Corporate income tax	$40.5	$37.1	12.0%	9.3%
Individual income tax on business income	$36.3	$33.0	10.7%	10.0%
Excise taxes	$29.4	$24.9	8.7%	18.0%
Corporate and business license	$25.5	$25.2	7.5%	1.3%
Insurance premiums taxes	$16.5	$15.9	4.9%	3.7%
Public utility taxes	$14.9	$15.0	4.4%	-0.6%
Severance taxes	$14.7	$11.2	4.3%	31.2%
Property taxes on business property	$9.0	$9.2	2.7%	-2.1%
Other business taxes	$9.4	$8.7	2.8%	7.2%
Total business taxes	**$338.7**	**$308.5**	**100.0%**	**9.8%**

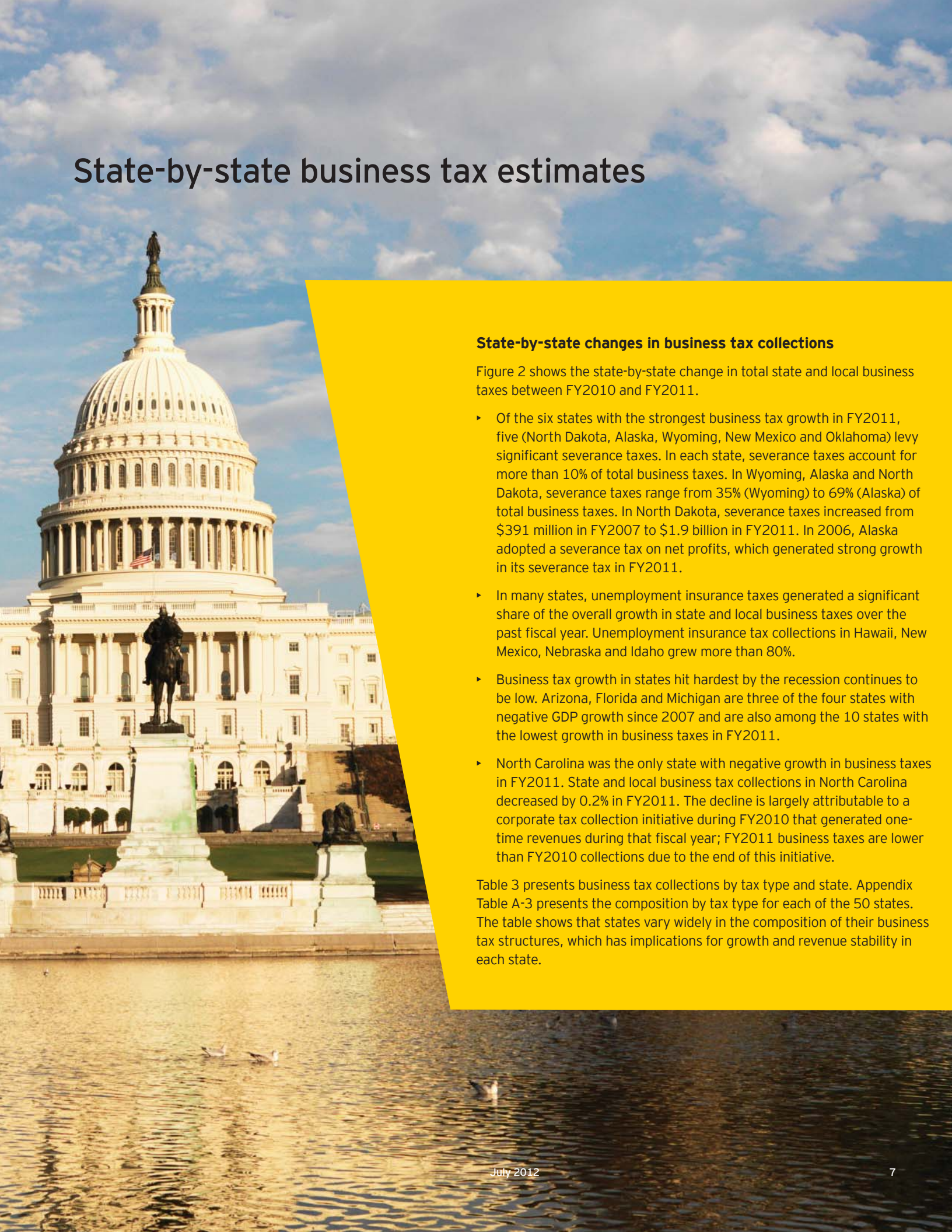
Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Table 2B. Local business taxes – FY2011 (US$billion)

Local business taxes	Local business taxes FY2011	Local business taxes FY2010	% total local business taxes	One-year growth, local business taxes
Property taxes on business property	$235.8	$239.4	77.9%	-1.5%
General sales taxes on business inputs	$28.4	$27.5	8.9%	3.4%
Public utility taxes	$13.9	$13.9	4.5%	0.0%
Excise taxes	$5.6	$5.5	1.8%	0.8%
Other business taxes	$21.4	$21.2	6.9%	0.9%
Total business taxes	**$305.1**	**$307.5**	**100.0%**	**-0.8%**

Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

State-by-state business tax estimates



State-by-state changes in business tax collections

Figure 2 shows the state-by-state change in total state and local business taxes between FY2010 and FY2011.

- Of the six states with the strongest business tax growth in FY2011, five (North Dakota, Alaska, Wyoming, New Mexico and Oklahoma) levy significant severance taxes. In each state, severance taxes account for more than 10% of total business taxes. In Wyoming, Alaska and North Dakota, severance taxes range from 35% (Wyoming) to 69% (Alaska) of total business taxes. In North Dakota, severance taxes increased from $391 million in FY2007 to $1.9 billion in FY2011. In 2006, Alaska adopted a severance tax on net profits, which generated strong growth in its severance tax in FY2011.
- In many states, unemployment insurance taxes generated a significant share of the overall growth in state and local business taxes over the past fiscal year. Unemployment insurance tax collections in Hawaii, New Mexico, Nebraska and Idaho grew more than 80%.
- Business tax growth in states hit hardest by the recession continues to be low. Arizona, Florida and Michigan are three of the four states with negative GDP growth since 2007 and are also among the 10 states with the lowest growth in business taxes in FY2011.
- North Carolina was the only state with negative growth in business taxes in FY2011. State and local business tax collections in North Carolina decreased by 0.2% in FY2011. The decline is largely attributable to a corporate tax collection initiative during FY2010 that generated one-time revenues during that fiscal year; FY2011 business taxes are lower than FY2010 collections due to the end of this initiative.

Table 3 presents business tax collections by tax type and state. Appendix Table A-3 presents the composition by tax type for each of the 50 states. The table shows that states vary widely in the composition of their business tax structures, which has implications for growth and revenue stability in each state.

Figure 2. Change in state and local business taxes by state – FY2010-FY2011
(Percentage change in total state and local business taxes)

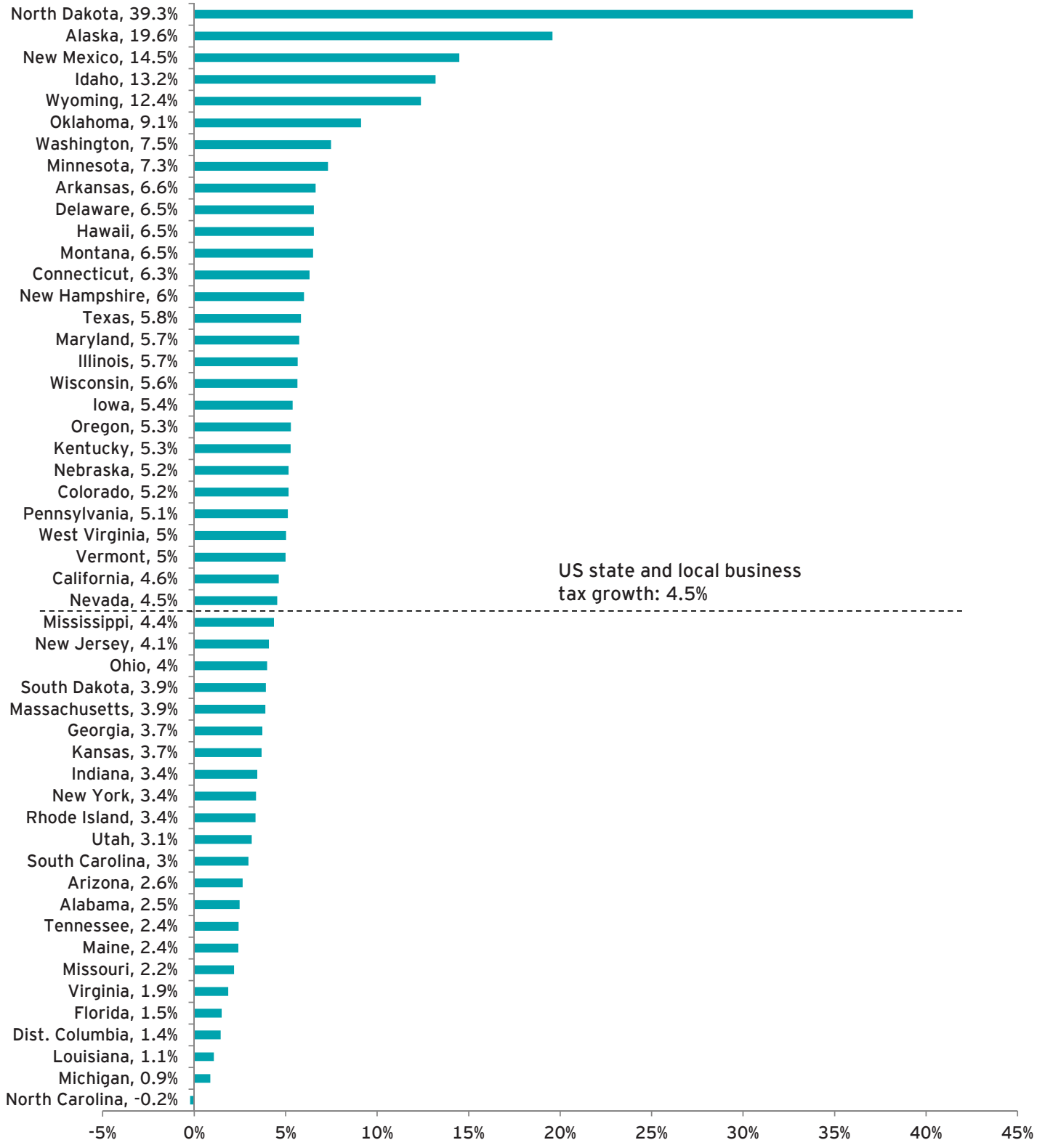


Table 3. State and local business taxes, by major tax type, by state – FY2011 (US$billion)

State	Property tax	Sales tax	Excise tax	Corporate income	UI tax	Individual income tax on business income	License and other taxes*	Total business tax
Alabama	$1.8	$1.4	$1.6	$0.3	$0.5	$0.3	$1.0	$6.9
Alaska	0.8	–	0.1	0.7	0.1	–	4.3	6.1
Arizona	4.9	3.0	1.0	0.6	0.4	0.3	0.6	10.8
Arkansas	0.9	1.1	0.6	0.4	0.4	0.3	0.3	4.0
California	29.8	17.7	11.1	9.6	5.6	8.0	8.1	89.9
Colorado	4.5	2.4	0.9	0.4	0.5	0.8	0.6	10.1
Connecticut	2.3	1.6	0.9	0.7	0.7	0.8	0.4	7.4
Delaware	0.3	–	0.2	0.3	0.1	0.1	1.1	2.2
Florida	20.5	7.1	8.1	1.9	1.4	–	2.3	41.2
Georgia	6.3	3.8	1.7	0.7	0.7	1.1	0.6	14.8
Hawaii	1.0	0.8	0.6	0.1	0.2	0.1	0.1	3.0
Idaho	0.8	0.3	0.2	0.2	0.3	0.2	0.2	2.2
Illinois	12.7	3.7	4.9	1.9	2.1	1.4	1.6	28.3
Indiana	5.3	2.0	0.7	0.7	0.6	0.6	0.3	10.3
Iowa	2.8	1.1	0.4	0.3	0.5	0.5	0.4	6.0
Kansas	2.6	1.5	0.5	0.2	0.4	0.4	0.3	5.9
Kentucky	2.0	1.3	1.3	0.6	0.5	0.5	0.7	6.9
Louisiana	2.5	4.2	1.1	0.2	0.2	0.3	1.1	9.7
Maine	1.7	0.4	0.3	0.2	0.2	0.2	0.2	3.0
Maryland	2.3	1.6	1.8	0.8	0.9	0.9	1.1	9.3
Massachusetts	6.2	1.9	0.9	1.9	1.8	1.5	0.7	14.9
Michigan	6.4	3.1	1.2	0.7	1.6	0.8	0.8	14.6
Minnesota	3.8	2.1	1.7	1.0	1.0	0.8	0.7	11.1
Mississippi	2.0	1.1	0.6	0.4	0.1	0.2	0.5	4.9
Missouri	3.4	2.2	1.1	0.3	0.6	0.6	0.8	9.1
Montana	0.8	–	0.2	0.1	0.1	0.1	0.5	1.9
Nebraska	1.7	0.9	0.4	0.2	0.2	0.3	0.3	3.9
Nevada	2.0	1.3	0.9	–	0.3	–	1.5	6.1
New Hampshire	1.2	–	0.4	0.6	0.2	0.0	0.2	2.6
New Jersey	9.6	3.2	2.0	2.2	2.4	1.2	1.2	21.8
New Mexico	0.7	1.5	0.4	0.2	0.2	0.1	1.0	4.1
New York	22.8	12.5	6.7	9.2	3.0	6.0	3.3	63.5
North Carolina	3.8	3.1	1.9	1.1	0.9	1.1	1.1	12.9
North Dakota	0.6	0.4	0.2	0.2	0.1	0.1	2.0	3.4
Ohio	7.0	4.1	2.6	0.7	1.3	1.3	3.0	20.1
Oklahoma	1.5	1.9	0.5	0.4	0.2	0.4	1.4	6.4
Oregon	2.3	–	0.7	0.5	0.9	0.7	0.9	5.9
Pennsylvania	8.8	3.6	3.4	2.0	2.6	1.7	3.3	25.3
Rhode Island	1.1	0.4	0.3	0.1	0.2	0.1	0.1	2.4
South Carolina	3.4	1.0	0.7	0.2	0.3	0.3	0.8	6.7
South Dakota	0.6	0.6	0.2	0.0	0.1	–	0.1	1.6
Tennessee	3.0	2.9	1.2	1.1	0.7	0.0	1.1	10.0
Texas	25.0	14.1	6.8	–	2.4	–	8.4	56.8
Utah	1.6	0.8	0.5	0.2	0.2	0.3	0.3	3.9
Vermont	0.9	0.1	0.3	0.1	0.1	0.1	0.1	1.6
Virginia	6.3	1.6	2.2	0.8	0.6	0.9	1.5	13.8
Washington	4.1	7.3	2.5	–	1.4	–	1.0	16.3
West Virginia	1.1	0.4	0.7	0.3	0.2	0.2	0.8	3.6
Wisconsin	4.5	1.8	1.2	0.9	1.0	0.5	0.8	10.5
Wyoming	1.1	0.6	0.1	–	0.1	–	1.1	2.9
District of Columbia	1.7	0.3	0.4	0.3	0.1	0.3	0.1	3.3
United States	**$244.9**	**$129.7**	**$81.0**	**$46.3**	**$41.2**	**$36.3**	**$64.5**	**$643.9**

Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances,
**Taxes categorized under 'other' include death and gift taxes, documentary and stock transfer taxes, severance taxes and local gross receipts taxes.*
Note: "–" indicates zero collections; "0.0" indicates collections of less than $50 million.

Comparing state business tax levels

A state's business tax burden can be measured in many ways, including the level of business taxes compared to the level of economic activity that is being taxed and the final incidence of business taxes, after they have been shifted to consumers or owners of factors of production, including workers.[4] Because state business tax bases include a diverse mixture of receipts — net income, input purchases, payroll, property and other tax bases — a broad measure of a state's overall economic activity should be used to determine the measure of aggregate business tax burden that can be compared across states.

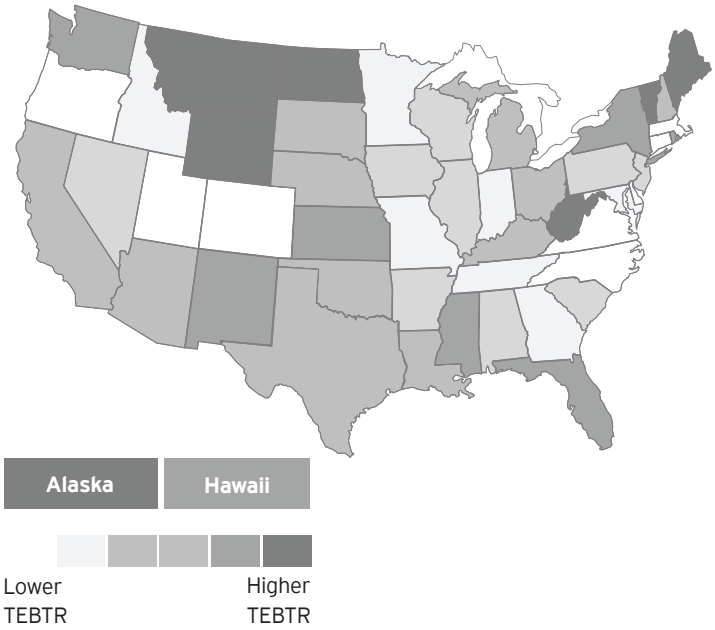
The last column in Table 4 presents state-by-state estimates of the total effective business tax rate (TEBTR) imposed on business activity by state and local governments, which is mapped in Figure 3. The TEBTR is measured as the ratio of state and local business taxes to private-sector gross state product (GSP), the total value of a state's annual production of goods and services by the private sector. The average TEBTR across all states is 5.0%; TEBTRs range from 3.5% in Oregon to 15.4% in Alaska.

While the business TEBTRs provide a starting point for comparing burdens across states, they do not provide sufficient information to evaluate a state's competitiveness. For example, Indiana has a TEBTR below the national average, but derives 70% of its business tax revenue from sales and property taxes, which are origin-based taxes on business capital that may negatively impact competitiveness. States with the highest TEBTRs tend to be the states with significant severance taxes on natural resources, which is included in the "other taxes" category in Table 3. To the extent that severance taxes are shifted forward in higher prices to consumers, they would not be a "burden" on domestic production and in-state residents but would instead fall on consumers of the natural resource who are typically located outside the state. More generally, a state with an average overall TEBTR may impose relatively high taxes on capital-intensive manufacturers, while imposing relatively low taxes on labor-intensive service industries. As a result, a state with such a tax structure and composition may create disincentives for locating new plant and equipment in the state.

It is also important to note that the TEBTR is a measure of the average tax burden on existing businesses in a state rather than a measure of the marginal tax that would be borne by a company investing in a new facility. For this reason, the TEBTR provides one metric that can be used to evaluate a state's business tax structure, but is not a clear indicator of the competitiveness of a state's business tax system in terms of attracting new investment.

For an analysis of the competitiveness of state and local taxes on new business investment, see the recent EY/COST study, "Competitiveness of State and Local Business Taxes on New Investment," released in April 2011. That study presents a measure of business tax competitiveness in each state by examining the incremental state and local tax burden on a representative investment in selected industries. North Carolina, for example, has the lowest TEBTR but in a recent analysis of marginal effective tax rates on new mobile capital investments by selected industries, the state's ETR on new investment is higher than the US average.

Figure 3. TEBTR by state, FY2011 (state and local business taxes divided by private sector gross state product in each state)



Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Table 4. State versus local business taxes and business taxes as a share of private sector GSP, by state — FY2011 (US$billion)

	State taxes		Local taxes		State and local taxes		
State	Business	Total	Business	Total	Business	Total	% of GSP*
Alabama	$4.0	$8.4	$2.9	$5.3	$6.9	$13.7	4.9%
Alaska	5.4	4.6	0.7	1.5	6.1	6.1	15.4%
Arizona	4.9	10.5	5.9	9.6	10.8	20.1	4.9%
Arkansas	3.1	7.6	0.9	1.8	4.0	9.4	4.5%
California	51.5	109.7	38.4	78.2	89.9	187.9	5.3%
Colorado	3.8	9.0	6.3	10.6	10.1	19.6	4.5%
Connecticut	5.0	12.9	2.4	9.9	7.4	22.9	3.6%
Delaware	1.8	2.9	0.4	0.9	2.2	3.7	3.7%
Florida	15.8	32.4	25.4	42.9	41.2	75.3	6.3%
Georgia	5.8	15.3	9.0	16.6	14.8	32.0	4.2%
Hawaii	1.7	4.9	1.2	1.8	3.0	6.7	5.9%
Idaho	1.3	3.1	0.9	1.5	2.2	4.6	4.6%
Illinois	13.1	31.4	15.2	29.5	28.3	60.9	4.8%
Indiana	4.8	14.3	5.5	8.9	10.3	23.2	4.2%
Iowa	2.7	7.2	3.2	5.2	6.0	12.4	4.7%
Kansas	2.8	6.7	3.1	5.3	5.9	12.0	5.5%
Kentucky	4.5	9.9	2.4	4.3	6.9	14.2	5.1%
Louisiana	4.5	8.9	5.2	7.0	9.7	15.9	4.5%
Maine	1.4	3.6	1.7	2.5	3.0	6.1	6.9%
Maryland	6.3	15.7	3.0	12.2	9.3	27.9	3.8%
Massachusetts	8.5	21.6	6.4	14.1	14.9	35.7	4.3%
Michigan	8.7	24.1	5.9	14.8	14.6	38.8	4.4%
Minnesota	7.5	18.0	3.6	7.4	11.1	25.4	4.5%
Mississippi	2.7	6.4	2.1	2.8	4.9	9.2	6.2%
Missouri	3.8	10.3	5.2	9.8	9.1	20.0	4.2%
Montana	1.2	2.2	0.7	1.2	1.9	3.4	6.0%
Nebraska	1.8	3.9	2.1	3.7	3.9	7.6	4.9%
Nevada	3.3	6.1	2.8	5.0	6.1	11.2	5.3%
New Hampshire	1.5	2.2	1.1	3.2	2.6	5.4	4.6%
New Jersey	12.0	27.9	9.8	27.0	21.8	54.9	5.1%
New Mexico	2.9	4.5	1.3	2.2	4.1	6.7	6.6%
New York	26.9	66.1	36.6	75.8	63.5	141.9	6.2%
North Carolina	8.1	22.3	4.8	11.6	12.9	33.9	3.5%
North Dakota	2.8	2.7	0.6	1.0	3.4	3.7	10.4%
Ohio	11.3	24.7	8.8	22.2	20.1	47.0	4.8%
Oklahoma	3.8	7.2	2.6	4.1	6.4	11.4	5.1%
Oregon	2.9	8.1	3.0	6.0	5.9	14.1	3.5%
Pennsylvania	14.9	32.3	10.4	23.9	25.3	56.2	5.0%
Rhode Island	1.2	2.8	1.1	2.5	2.4	5.2	5.6%
South Carolina	2.6	7.1	4.0	5.9	6.7	13.0	5.0%
South Dakota	0.8	1.3	0.8	1.3	1.6	2.7	4.6%
Tennessee	5.9	11.2	4.1	8.3	10.0	19.5	4.4%
Texas	27.1	40.8	29.7	46.8	56.8	87.6	5.1%
Utah	1.8	5.2	2.1	3.6	3.9	8.8	3.6%
Vermont	1.3	2.6	0.3	0.5	1.6	3.0	7.3%
Virginia	5.2	16.8	8.7	16.2	13.8	33.0	4.0%
Washington	10.4	17.1	5.9	11.5	16.3	28.7	5.5%
West Virginia	2.3	4.8	1.3	1.8	3.6	6.6	6.9%
Wisconsin	5.8	15.1	4.7	10.7	10.5	25.8	4.7%
Wyoming	1.9	2.2	1.0	1.4	2.9	3.6	9.3%
District of Columbia	3.3	5.5	0.0	0.0	3.3	5.5	4.9%
United States	**$338.7**	**$742.3**	**$305.1**	**$601.8**	**$643.9**	**$1,344.0**	**5.0%**

*Average of FY2010 and FY2011 private-industry GSP. This is the total effective business tax rate (TEBTR) on economic activity occurring within the state.

Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

State responses to a changing economy

Over the past four years, states have faced significant fiscal challenges. The recession that began in December 2007 resulted in significant declines in state and local tax revenues from which states have largely recovered in the past fiscal year. Although business property, corporate income and sales taxes on business inputs are still the largest business taxes, strong growth in other taxes drove overall growth in state and local business taxes in FY2011. Four taxes that have grown significantly over the past fiscal year are unemployment insurance taxes, health care provider taxes, natural resource severance taxes and individual income taxes on pass-through business income.

Unemployment insurance taxes

At the height of the recession, states borrowed from the federal government to fund unemployment insurance (UI) benefit payments. In 2009 and 2010, many states were reluctant to increase UI contribution rates and accumulated substantial debts owed to the federal government. In FY2010, these debts exceeded $40 billion. In FY2011, states paid down their UI trust fund debts and began raising contribution rates significantly, either through increases in tax rates or increases in the state taxable wage base.

From 2010 to 2011, 17 states increased their taxable wage base. These tax base increases coupled with increased employer UI contribution rates resulted in increased overall effective tax rates in 43 states. The increase in taxable wage bases and contribution rates resulted in a significant increase in the average employer contribution rate on total wages. In 2010, the average contribution rate (contributions divided by total wages) was 0.80%. By 2011, this average rate increased to 0.97%. For the average business, this translates to a 21% increase in overall unemployment insurance contributions. In 14 states, FY2011 UI taxes increased more than 50% compared to FY2010.

Even with the significant increase in UI contributions and the associated reduction in outstanding state UI trust fund debts, the federal government has reduced federal UI credit rates for 27 states because of outstanding debts owed to the federal government. As shown in Table 5, 10 states account for more than 80% of the total debt.

Table 5. State unemployment insurance trust fund debt as of June 2012 (US$billion)

State	UI trust fund debt
California	$8.8
New York	$2.8
Pennsylvania	$2.5
North Carolina	$2.5
Ohio	$1.8
Indiana	$1.7
Illinois	$1.1
New Jersey	$1.0
Kentucky	$1.0
Wisconsin	$0.9
Other states	$5.1
Total	**$29.3**

Figures may not sum due to rounding.
Source: Department of Labor, Employment and Training Administration.

Health care provider taxes

Already facing significant revenue shortfalls following the recession, states were confronted in 2011 with the additional fiscal challenge of rising Medicaid expenditures resulting from expanded coverage requirements and high unemployment, which increased the number of individuals with income low enough to meet Medicaid eligibility requirements. States have responded to increased Medicaid funding requirements by reducing payments to providers while adopting and expanding health care provider taxes on hospitals, nursing homes and certain other medical service providers. Federal matching funds for state funding of Medicaid mean that each dollar of health care provider tax generates more than one dollar of overall state revenue, increasing the incentive for states to adopt these taxes.

As of 2012, 48 states impose taxes on health care providers and the number of states with Medicaid health care provider taxes on hospitals increased from 23 states in 2009 to 39 in 2012.[5] In FY2011, provider taxes are estimated to be approximately $10 billion, although this tax category is not tracked separately in U.S. Census Bureau data and is an estimate based on amounts reported by individual states.[6] These provider taxes, which are generally included in this study in the "excise tax" category, increased by an estimated $3.7 billion due to states adopting and expanding the taxes in 2010 and 2011.[7]

Severance taxes

Severance taxes are imposed on natural resource industries in 35 states and include taxes on oil, natural gas, mining and other extractors of natural resources. Many states saw their severance tax collections increase significantly in FY2011 due to increases in the level of oil and natural gas production, higher crude oil prices, and increased profitability of the oil and gas industry.

Total state and local severance tax collections grew by 31% from FY2010 to FY2011, an increase of $3.5 billion. Four states account for 80% of the severance tax increase: Texas, North Dakota and Wyoming each had FY2011 increases in severance tax collections that exceeded 50% while Alaska had a 26% increase in severance taxes that totaled nearly $900 million.

Taxes on pass-through business income

Taxes on pass-through business income grew by an estimated 10.0% in FY2011. The growth in individual income taxes on business income resulted from higher overall profitability of businesses and an increased number of businesses operating as limited liability companies, partnerships and S-corporations. In several states, business entity taxes that are not based on income also generate taxes on these business entities. These non-income taxes on business entities are shown in Table 2.

Conclusion

Total state and local business taxes increased by 4.2% in FY2011, signaling a return to growth after two fiscal years of declining revenues. In contrast to previous economic cycles, which were marked by stable local property tax collections, the current recovery has been accompanied by declining property taxes. Local governments, which rely significantly on the property tax, are generally unable to diversify their revenue mix and will likely be forced to confront stagnant revenue growth in the near future. At the state level, many of the revenue sources tapped for growth during FY2011 are special purpose taxes on specific industries or used to fund specific activities and may not be sources of long-term revenue growth. As legislators and businesses confront rising Medicaid costs, high unemployment, and continued demands on state and local resources, businesses will need to be active participants in the policy discussion.

Appendix: Supplemental tables

Appendix Table A1. Total state and local business taxes – FY1990-FY2011 (US$billion)

State and local taxes	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total business taxes*	$229.4	$303.2	$382.4	$395.3	$401.8	$424.2	$459.9	$510.9	$553.3	$609.6	$624.6	$619.5	$616.0	$643.9
Individual income taxes on non-business income	99.1	128.3	196.5	209.7	188.0	185.5	197.7	210.5	234.0	254.4	267.9	234.5	224.1	246.5
Other non-business taxes	185.5	244.9	313.7	324.3	336.2	356.5	383.6	408.5	454.8	455.1	473.4	490.3	501.0	513.2
Total state and local taxes	**$514.0**	**$676.4**	**$892.6**	**$929.4**	**$926.1**	**$966.2**	**$1,041.2**	**$1,130.0**	**$1,242.1**	**$1,319.1**	**$1,366.0**	**$1,344.3**	**$1,341.1**	**$1,403.5**

Composition of state and local taxes	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total business taxes*	44.5%	45.1%	42.8%	43.5%	44.1%	44.8%	44.7%	45.2%	44.5%	46.2%	45.7%	46.1%	45.9%	45.9%
Individual income taxes on non-business income	19.4%	18.7%	22.1%	21.6%	19.5%	18.3%	18.4%	18.6%	18.8%	19.3%	19.6%	17.4%	16.7%	17.6%
Other non-business taxes	36.1%	36.2%	35.1%	34.9%	36.3%	36.9%	36.8%	36.2%	36.6%	34.5%	34.7%	36.5%	37.4%	36.6%
Total state and local taxes	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

**Includes individual income taxes on pass-through business income.*

Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Appendix Table A2. Composition of state and local business taxes – FY1990-FY2011 (US$billion)

Business taxes	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Property tax on business property	$84.7	$110.7	$136.8	$142.6	$152.9	$160.9	$169.7	$176.6	$187.9	$218.0	$222.0	$245.3	$248.6	$244.9
General sales and use tax on inputs	$53.4	$70.2	$94.4	$97.6	$97.9	$100.9	$107.3	$115.2	$123.8	$131.7	$134.6	$127.7	$123.3	$129.7
Corporate net income	$23.7	$31.7	$36.4	$35.8	$28.5	$31.9	$34.1	$43.5	$53.3	$61.0	$59.2	$46.9	$42.7	$46.3
Unemployment insurance tax	$12.4	$15.8	$20.9	$20.8	$21.0	$23.9	$31.9	$35.5	$36.4	$35.8	$32.5	$31.4	$32.4	$41.2
Business license tax	$7.3	$11.4	$14.8	$15.0	$17.0	$16.8	$18.9	$29.5	$32.9	$34.0	$36.6	$37.1	$37.0	$37.3
Individual income tax	$6.6	$9.6	$15.1	$16.3	$14.8	$14.8	$17.5	$30.4	$33.1	$35.5	$37.4	$34.5	$33.0	$36.3
Excise taxes	$10.6	$16.0	$20.1	$20.2	$20.8	$21.9	$23.4	$23.9	$25.1	$28.5	$29.8	$28.8	$30.5	$35.0
Public utility tax	$11.4	$15.0	$17.7	$17.9	$20.3	$21.2	$21.3	$22.6	$23.6	$27.1	$28.2	$28.7	$28.9	$28.8
Insurance premium tax	$7.4	$8.6	$9.8	$10.3	$11.2	$12.6	$14.0	$14.9	$15.6	$16.1	$16.5	$15.8	$16.6	$17.2
Other business taxes	$11.8	$14.1	$16.5	$18.9	$17.4	$19.5	$21.8	$18.8	$21.6	$21.9	$27.9	$23.4	$23.1	$27.2
Total business taxes	**$229.4**	**$303.2**	**$382.4**	**$395.3**	**$401.8**	**$424.2**	**$459.9**	**$510.9**	**$553.3**	**$609.6**	**$624.6**	**$619.5**	**$616.0**	**$643.9**

Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Appendix Table A3. Distribution of state and local business taxes, by type and state — FY2011

State	Property tax	Sales tax	Excise tax	Corporate income tax	UI tax	Individual income tax on pass-through income	License and other taxes*	Total business taxes
Alabama	26.4%	19.9%	23.4%	4.4%	6.7%	5.0%	14.3%	100.0%
Alaska	13.4%	0.0%	2.0%	11.8%	2.1%	0.0%	70.7%	100.0%
Arizona	45.2%	28.1%	9.6%	5.2%	3.4%	3.1%	5.4%	100.0%
Arkansas	23.0%	28.7%	14.1%	9.5%	9.2%	7.3%	8.4%	100.0%
California	33.1%	19.6%	12.4%	10.7%	6.2%	8.9%	9.0%	100.0%
Colorado	44.5%	23.7%	8.6%	3.8%	5.2%	7.8%	6.4%	100.0%
Connecticut	30.9%	21.7%	11.8%	9.1%	9.9%	11.4%	5.2%	100.0%
Delaware	15.2%	0.0%	10.8%	14.9%	4.4%	5.1%	49.6%	100.0%
Florida	49.8%	17.2%	19.6%	4.5%	3.3%	0.0%	5.6%	100.0%
Georgia	42.5%	25.4%	11.4%	4.5%	4.8%	7.4%	4.0%	100.0%
Hawaii	34.3%	27.5%	19.6%	2.3%	6.8%	4.5%	5.0%	100.0%
Idaho	37.2%	14.9%	9.4%	7.6%	12.5%	9.1%	9.4%	100.0%
Illinois	44.8%	13.0%	17.4%	6.5%	7.5%	5.0%	5.7%	100.0%
Indiana	51.8%	19.6%	7.1%	7.0%	6.0%	6.0%	2.6%	100.0%
Iowa	47.0%	18.3%	7.3%	4.2%	8.9%	8.1%	6.3%	100.0%
Kansas	44.1%	24.6%	8.9%	4.2%	6.3%	6.7%	5.3%	100.0%
Kentucky	28.8%	19.4%	19.2%	8.9%	6.7%	7.1%	9.9%	100.0%
Louisiana	25.7%	43.6%	11.7%	2.0%	2.2%	3.1%	11.7%	100.0%
Maine	55.7%	12.2%	8.8%	6.9%	5.0%	5.9%	5.4%	100.0%
Maryland	24.5%	17.1%	19.2%	8.3%	9.5%	10.0%	11.4%	100.0%
Massachusetts	41.3%	12.9%	6.2%	12.9%	11.9%	9.9%	4.8%	100.0%
Michigan	43.9%	20.9%	8.1%	4.9%	11.0%	5.3%	5.8%	100.0%
Minnesota	34.1%	18.7%	15.3%	9.1%	9.2%	7.1%	6.5%	100.0%
Mississippi	41.8%	22.4%	12.5%	7.2%	2.9%	3.9%	9.4%	100.0%
Missouri	37.8%	24.2%	12.6%	3.6%	6.8%	6.3%	8.7%	100.0%
Montana	44.3%	0.0%	11.7%	6.7%	6.4%	6.7%	24.3%	100.0%
Nebraska	43.3%	22.5%	10.0%	4.0%	5.5%	7.8%	7.0%	100.0%
Nevada	33.2%	22.2%	15.3%	0.0%	5.1%	0.0%	24.2%	100.0%
New Hampshire	47.6%	0.0%	15.0%	22.8%	6.6%	0.4%	7.6%	100.0%
New Jersey	43.9%	14.6%	9.2%	10.2%	11.1%	5.4%	5.6%	100.0%
New Mexico	18.0%	35.1%	9.2%	5.6%	5.9%	3.0%	23.2%	100.0%
New York	35.9%	19.7%	10.6%	14.4%	4.8%	9.4%	5.1%	100.0%
North Carolina	29.6%	23.9%	14.6%	8.4%	6.8%	8.1%	8.6%	100.0%
North Dakota	16.1%	11.1%	5.8%	4.7%	2.2%	2.5%	57.7%	100.0%
Ohio	34.8%	20.7%	13.2%	3.6%	6.5%	6.2%	15.0%	100.0%
Oklahoma	23.9%	29.8%	8.6%	5.5%	3.4%	6.9%	21.8%	100.0%
Oregon	38.9%	0.0%	12.0%	8.8%	14.5%	11.4%	14.4%	100.0%
Pennsylvania	34.8%	14.3%	13.4%	7.8%	10.1%	6.6%	12.9%	100.0%
Rhode Island	46.8%	16.0%	13.1%	6.2%	9.9%	4.8%	3.1%	100.0%
South Carolina	51.5%	14.4%	10.1%	3.2%	4.8%	4.4%	11.6%	100.0%
South Dakota	38.3%	36.6%	10.2%	1.0%	4.4%	0.0%	9.6%	100.0%
Tennessee	29.9%	28.5%	12.2%	10.7%	7.1%	0.4%	11.3%	100.0%
Texas	44.0%	24.9%	12.0%	0.0%	4.3%	0.0%	14.9%	100.0%
Utah	40.5%	21.9%	12.9%	6.4%	4.5%	6.6%	7.3%	100.0%
Vermont	55.4%	8.2%	16.6%	6.6%	5.7%	4.2%	3.3%	100.0%
Virginia	45.2%	11.8%	15.9%	5.8%	4.1%	6.2%	11.1%	100.0%
Washington	25.2%	45.0%	15.1%	0.0%	8.7%	0.0%	6.0%	100.0%
West Virginia	29.7%	9.6%	19.5%	8.4%	5.6%	5.1%	22.0%	100.0%
Wisconsin	42.6%	16.7%	11.0%	8.1%	9.1%	5.2%	7.3%	100.0%
Wyoming	36.7%	19.2%	2.5%	0.0%	3.3%	0.0%	38.2%	100.0%
District of Columbia	51.4%	9.2%	11.7%	10.3%	4.4%	9.7%	3.4%	100.0%
United States	**38.0%**	**20.1%**	**12.6%**	**7.2%**	**6.4%**	**5.6%**	**10.0%**	**100.0%**

Figures may not sum due to rounding.
Source: Ernst & Young LLP estimates based on data from the U.S. Census Bureau, State & Local Government Finances.

Endnotes

[1] The general methodology used to estimate state and local business taxes is described in detail in the Appendix to the EY/COST FY2005 50-State Business Tax study published in March 2006. Note that business tax estimates for prior years have been revised from those published in earlier editions of this study due to feedback from state tax agencies, the use of updated and more detailed information on local business taxes, and refinements to the property tax estimation methodology to reflect the rapid rise in the value of residential property since 2002. All references to business taxes in prior fiscal years refer to the updated estimates included in this study, rather than the previously published estimates.

[2] A more detailed analysis of state and local sales taxation of business inputs is presented in Robert Cline, John Mikesell, Tom Neubig and Andrew Phillips, "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," January 25, 2005. (Also in State Tax Notes, January 28, 2005.)

[3] Based on Ernst & Young LLP Analysis of Bureau of Economic Analysis data from National Income and Product Accounts Table 3.3 State and Local Government Current Receipts and Expenditures.

[4] For an analysis of the incidence of state and local taxes on business, see Robert Cline, Andrew Phillips, Joo Mi Kim and Tom Neubig, "The Economic Incidence of Additional State Business Taxes," State Tax Notes, Tax Analysts, January 11, 2010.

[5] National Council of State Legislatures.

[6] The estimated health care provider taxes are based on amounts reported for FY2011 by selected states rather than U.S. Census Bureau data used elsewhere in the analysis. In several states, health care provider taxes were enacted during FY2011 that will generate revenue in FY2012.

[7] National Council of State Legislatures.

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Competitiveness of state and local business taxes on new investment

Ranking states by tax burden on new investment

April 2011

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This study was prepared by the Quantitative Economics and Statistics Practice (QUEST) of Ernst & Young LLP in conjunction with the Council On State Taxation (COST). QUEST is a group of economists, statisticians, and tax policy researchers within Ernst & Young LLP's National Tax practice, located in Washington, D.C. QUEST provides quantitative advisory services to private and public sector clients that enhance business processes, support regulatory compliance, analyze proposed policy issues and provide litigation support.

COST is a nonprofit trade association based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Executive summary

As states recover from the recent recession, legislators and policy-makers are focusing attention on state policies designed to retain and expand employment and attract new investment. State and local business tax policy is an important element of this policy discussion, and legislators want to know how a state's current business tax system compares to other states considered to be competitors for jobs and investment.

This study provides a state-by-state comparison of the tax liabilities that new investments in selected industries or types of economic activities would incur in each state, taking into consideration state and local statutory tax provisions and the financial and economic characteristics of the new investments. The analysis focuses on capital investments in industries that have location choices, such as factories or headquarters, rather than those that are tied to a specific geography, such as retailers or hotels. The estimated tax burdens on selected investments are combined to provide an overall measure of the business tax competitiveness of each state.

The results reflect the type of analysis that businesses use to evaluate decisions about where to locate new capital investments in plant and equipment. The business tax competitive indexes reported in this study isolate the impact of state and local business tax systems on new capital investment, the cornerstone of state economic development. Typically, companies select the location for new investments by examining a wide range of tax system features and non-tax cost factors, such as labor, utility, and transportation costs. While non-tax cost factors are usually more significant in determining the overall cost of operating a facility in each state, tax factors can be a determining factor between states with otherwise similar non-tax costs.

Site selection projects typically occur in two phases. The first phase involves a high-level examination of operating cost and tax factors for a number of states. By eliminating states with out-of-line tax and non-tax cost factors from further consideration, the investor narrows its investigation to a "short list" of states with favorable characteristics. Typically, the tax factors considered in determining the short list of states include readily-available tax features, such as statutory tax rates and income apportionment formulas. Most investors then conduct a more thorough analysis of the tax implications of investing in each of the states on its short list. The competitiveness index reported in this study provides a more accurate measure of the taxes imposed on new investments than a simple comparison of statutory effective tax rates.

State and local taxes imposed on business are extensive and complex. Certain tax system features were not included in the analysis and are discussed in the limitations section, including mandatory unitary combined reporting, tax credits, industry-specific taxes, and

Table E-1. Top-10 and Bottom-10 states ranked by Ernst & Young LLP/COST business tax competitiveness, 2009

States with the lowest ETR on new investment			States with the highest ETR on new investment		
State	Effective tax rate	Rank	State	Effective tax rate	Rank
Maine	3.0%	1	West Virginia	9.7%	42
Oregon	3.8%	2	Alabama	9.7%	43
Ohio	4.4%	3	Mississippi	10.2%	44
Wisconsin	4.5%	4	Tennessee	10.3%	45
Illinois	4.6%	5	Hawaii	10.8%	46
Virginia	5.4%	6	Louisiana	11.1%	47
New Hampshire	5.4%	7	Kansas	11.2%	48
Delaware	5.7%	8	Rhode Island	11.5%	49
Wyoming	5.8%	9	District of Columbia	16.6%	50
Minnesota	6.0%	10	New Mexico	16.6%	51

unemployment insurance taxes. The methodology used to estimate the Ernst & Young LLP/Council On State Taxation (COST) business tax competitiveness index reported in this study provides an objective, systematic approach to summarizing the tax impacts of the complex systems of state and local taxes on different types of new mobile capital investments in each state in terms of the effective tax rate on returns from the investments. The approach combines estimates of the actual tax amounts imposed on hypothetical new investments with information on the nation-wide composition of recent new capital investment to create a weighted average of business tax burdens on the types of investments that states are currently pursuing. These overall tax burdens are summarized in the Ernst & Young LLP/ COST business tax competitiveness index.

Table E-1 identifies the 10 states with the highest and lowest effective tax rates for the types of new capital investments being made in the U.S.

As explained in detail in this report, the business tax burdens include all major state and local taxes imposed on business activities associated with new capital investments including:

- Income and franchise taxes on profits (including gross receipts taxes)
- Real and personal property taxes
- Sales taxes on business input purchases

The types of mobile capital investments analyzed include:

- Headquarters facilities
- Research and development facilities
- Office and call center facilities
- Durable manufacturing facilities
- Non-durable manufacturing facilities

The modeling of business tax burdens combines detailed information on tax provisions affecting the definition of tax bases, as well as statutory tax rates. The rankings show that differences in how states define tax bases are, for many states, more important in determining tax competitiveness than the statutory tax rates.

The results also clearly show that legislators need to examine the entire system of state and local business taxes, not just a single tax, in evaluating their state's tax competitiveness. In fact, the results suggest that legislators have not paid enough attention to the role of "sales" in understanding tax burdens imposed on business investments and on-going operations. This includes both (1) sales to businesses subject to sales taxes imposed on taxable products and (2) services purchased as business inputs, and the "sourcing" or geographic assignment of sales by business in determining instate corporate income and gross receipts tax bases. Because both sales taxes and entity-level business taxes are levied at high rates, variations in the definition of these tax bases have a significant impact on the competitiveness rankings presented in this study.

In addition to providing a snapshot at a point in time of the competitiveness of current state and local business tax systems, the competitiveness index provides an objective, systematic way for evaluating the positive or negative impacts of legislative tax changes on a state's competitiveness. These impacts will be visible in changes in the annual business tax competiveness index rankings over time.

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Introduction

When comparing the attractiveness of state tax systems to businesses making investments in new or expanded facilities, much of the focus of legislators and the public centers on statutory tax rates. These tax rates are often used in interstate comparisons to illustrate purported differences in the level of corporate income, sales and property taxes by comparing the statutory rates and other tax features rather than the total tax burden. Businesses contemplating a new investment, however, are concerned with the actual tax liability that results from an investment in a given location, not simply statutory tax features.

This analysis provides a state-by-state comparison of the tax liabilities that new investments in selected industries would incur, taking into consideration state and local statutory tax provisions and the financial and economic characteristics of the new investments. The resulting specific industry tax burdens are aggregated to provide an overall measure of the business tax competitiveness of each state. The results reflect the type of analysis undertaken by businesses when evaluating investments decisions to reveal the impact of state and local business tax systems on capital investment, the cornerstone of state economic development.

The business tax competitiveness analysis builds on a decade of Ernst & Young LLP's experience in analyzing state and local business taxes, drawing on the following:

- Ernst & Young LLP's annual study estimating total state and local taxes paid by business, done in conjunction with the COST, is used to identify the major taxes imposed in each state on new business investments in selected industries.[1]
- Ernst & Young LLP's annual study of the state-by-state amounts and industry distribution of new capital investments and jobs.[2] This information is used in the business competitiveness analysis to create an index that measures the relative business tax burdens for the types of mobile capital investments that businesses are actually making.

The methodology used in this business tax competitiveness study provides an overall index measuring the state and local taxes that new business investments face in each state. Unique features of the study include:

- The financial characteristics of new investments in each industry are held constant across the states. This allows isolation of the tax burden differences to the specific features of each state and local business tax system.
- The financial characteristics of the selected industries provide the level of financial detail needed to estimate the size of state and local business tax bases in each state. This includes detailed information on business purchases taxable under the sales tax, property taxes on real and personal property, gross receipts taxes and the sourcing and apportionment of corporate income and excise tax bases.
- The financial characteristics of the selected "representative" firms automatically weight the importance of each state and local tax in determining the overall competitiveness index. The weights assigned to each tax type (property tax, corporate income tax and sales tax on inputs, for example) recognize differences in the state and local tax mix across industries.

- The tax burdens for representative investments in selected industries are aggregated to derive a weighted-average competitiveness index for each state. The weights assigned to each industry's result when averaging to a single overall result are based on the relative importance of each type of capital investment in the mix of recent mobile capital investments in the US. In other words, the result for facilities that accounted for a larger share of recent investment is given more weight in the overall average than the result for facilities that generated a smaller share of the total investment. This approach provides an objective way of weighting the different industry tax burdens to derive an overall business tax competitiveness index for each state.
- The use of actual data on capital investments that businesses are undertaking nation-wide provides important information about how competitive current state and local business tax systems are for mobile capital investments.

It is important to note that while this analysis provides estimates of the state and local taxes that would be paid by businesses on a new investment, the analysis does not attempt to estimate the final economic incidence of those taxes.[3] The results presented in this study are also dependent on the facility types analyzed and the assumptions used in the analysis. In addition, the results are sensitive to certain assumptions, such as the distribution of nation-wide apportionment factors and the value of taxable property.

The Ernst & Young LLP business tax competitiveness index can be used by state legislators and officials to evaluate their current state and local tax systems and to identify tax changes that could improve their business tax competitiveness. The analysis focuses on taxes imposed on new capital investments. As states begin to recover from the recent recession, decision-makers will be focusing on economic development initiatives to retain and expand in-state jobs and investments in plant and equipment. This study's focus on capital investment also reflects the increasing international mobility of capital and associated jobs.

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[1]For the latest study, see Ernst & Young LLP, Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2009, March 2010.

[2]Ernst & Young LLP, 2010 US Investment Monitor: Tracking Mobile Capital Investments During the 2007-2009 Recession, February 2010 provides detailed information on capital investments by state and by industry.

[3]For an analysis of the economic incidence of state and local business taxes, see Cline, Robert; Andrew Phillips; Joo Mi Kim; and Tom Neubig, "The Economic Incidence of Additional State Business Taxes," State Tax Notes, January 11, 2010 p. 105.

Detailed description of approach

The Ernst & Young LLP/COST business tax competitiveness index presents a comparison of the state and local business taxes that would be incurred by a company making an investment in a new facility or expansion of an existing facility. This approach compares marginal taxes on new capital investment, rather than the average level of taxes paid by all businesses in the state. While both measures of tax (average and marginal) are of interest to policy-makers, marginal tax rates on new investment have the greatest impact on a state's economic development because these are the taxes that affect business investment decisions.[4]

To estimate these marginal taxes on new investment, the analysis uses the Ernst & Young LLP business tax competitiveness model (BTCM) to estimate the effective state and local taxes imposed on investment in each state. The following is a brief overview of the steps used in developing the BTCM and estimating the taxes paid by the expanding businesses.

- The first step of the analysis is the construction of financial profiles for each of the five facility types analyzed. The financial profiles are based on Internal Revenue Service (IRS) Statistics of Income data and other data that include information on assets, liabilities, receipts, deductions and net income. The financial profile is then projected for 30 years so that differences in the timing of certain taxes can be incorporated into the analysis.
- The analysis includes estimates of the major state and local taxes, including corporate income and alternative business income taxes, sales tax, property tax and net worth taxes. For the types of facilities included in the analysis, these taxes represent the overwhelming majority of total tax liability and provide a good indicator of the level of total state and local tax burden on a new investment.
- For each tax, the most significant tax system features are incorporated. For corporate/business income taxes, the model incorporates tax rates, base definitions (net income or alternate tax base), apportionment formula weights and sourcing of sales. For the sales tax, state and local sales rates are incorporated along with variations in the tax base for operating inputs and capital investment. The property tax considers tax rates on five major classes of real and personal property, to reflect both the level of the statutory tax rate as well as the breadth of the tax base.
- Taxes are estimated by year, considering changes in rates and other key tax system features scheduled to occur through 2014 under current law. For example, Indiana is phasing-in single sales factor apportionment through 2011 and the model reflects this phase-in rather than simply relying on the apportionment formula weight in 2009.
- Based on the taxes estimated for each year of the 30-year period, the before and after tax rate of return is estimated for each of the facility types. The effective tax rate is then calculated based on the estimated change in the rate of return. For example, if the rate of return falls from 15% to 13%, a two percentage point decrease, this translates into a 13.3% effective tax rate (the two percentage point decrease divided by the original 15% rate of return). The interpretation of this effective tax rate measure is that it represents the percentage change in the rate of return on the investment in a new facility due to state and local taxes.

Limitations of the analysis

While the estimates provide results that can be used to evaluate the competitiveness of each state's business tax system for the selected facility types included in the analysis, the study has several important limitations that should be understood when using the results:

- As explained in detail in a separate Ernst & Young LLP report, combined reporting may increase or decrease the additional corporate income taxes that the new investments would pay compared to states that require separate filing.[6] Given the fact that the impact of combined reporting is dependent upon the specific U.S.-wide operations of each taxpayer, the index calculations do not include any impact from combined reporting.
- State and local governments often offer significant discretionary tax credits, tax abatements and cash grants to companies locating a major facility in their state. These negotiated incentive programs vary by jurisdiction and can affect the attractiveness of a location to a potential investor. Similarly, companies locating a facility in an enterprise zone may qualify for reduced tax rates, abatements, or exemptions based on the geographic location of the facility within a state. Because they are not generally available to all taxpayers, neither negotiated incentives nor enterprise zone incentives are included in the analysis.
- Statutory investment and job-creation tax credits offered by many states can reduce tax costs for several years after the initial investment in a new facility. These credits often vary depending on the level of investment, number of jobs created and geographic location of the investment but are often limited to certain industries. Similarly, research and development credits can offset the ongoing tax costs by providing a credit equal to the incremental or total annual expenditure on research and development. These credits are not included in the analysis.
- The study's approach is to calculate the before-credit tax burdens on new investments; in other words, the study describes the competitiveness of the general state and local business tax structure, before targeted or negotiated incentives and credits. Significant tax credits are adopted in many states to offset non-competitive features of the general tax structure. Decision-makers need to understand how competitive the general tax system is before evaluating the role of credits and incentives.
- The analysis examines C corporations, which are the typical legal form of companies making large investments in new facilities. However, companies are increasingly organized as pass-through entities, such as limited liability companies and partnerships, which will incur individual income taxes. For companies organized as pass-through entities, individual income tax will be a significant factor in determining the overall state and local tax burden and is not considered in this analysis.
- Certain corporate income tax system features can significantly affect the amount of corporate income subject to tax in each state. Two important features not analyzed in this study are the treatment of foreign source income and combined reporting. Certain types of foreign source income from passive investments reported by a corporate taxpayer on its federal tax return are subject to corporate income tax at the state level by certain states, possibly increasing the amount of income subject to apportionment and, typically, the amount of tax.
- Tax compliance costs and enforcement actions vary across states and can contribute to the overall burden of a state and local business tax system. These costs are not considered in the analysis but can be significant for taxpayers.
- Unemployment insurance taxes represent a large tax cost for business taxpayers and tend to grow rapidly coming out of a recession as states replenish unemployment insurance funds. Based on the current level of unemployment and the balance of state unemployment trust funds, experience suggests that unemployment insurance contribution rates may increase by more than 50% over the next three years. Because the unemployment insurance contribution is typically determined by

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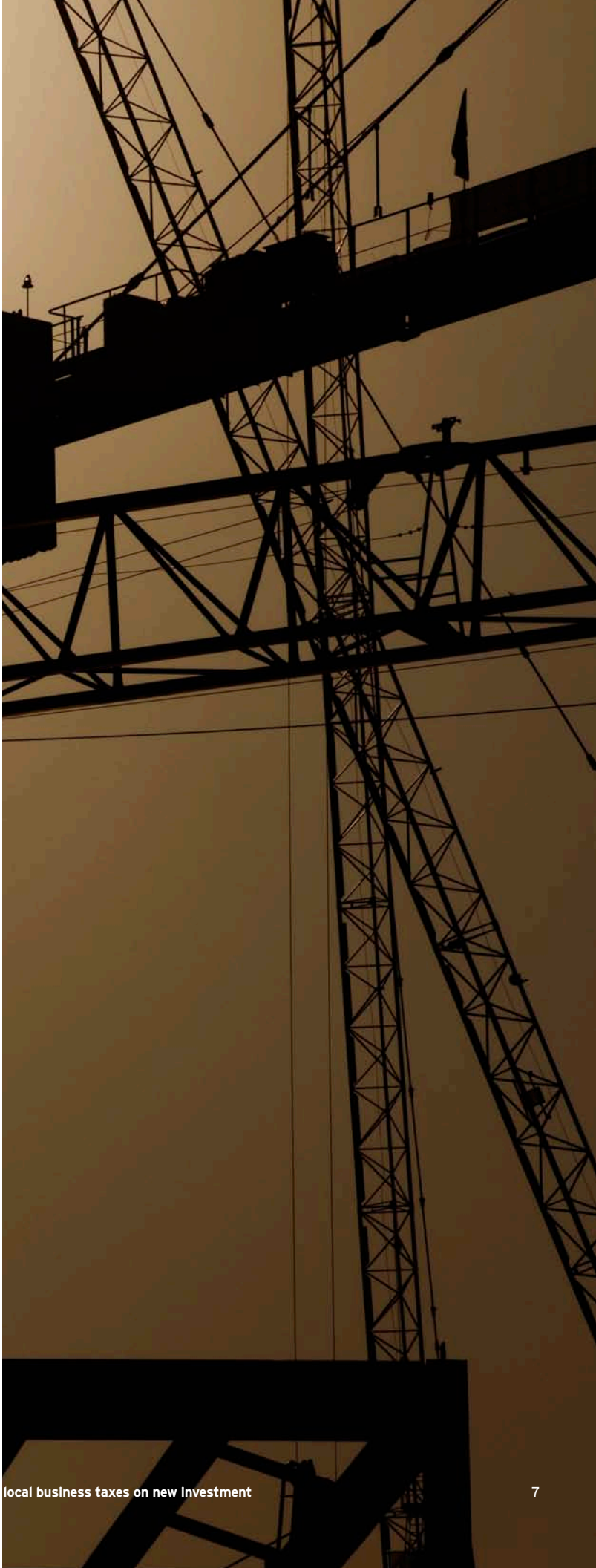
the unemployment benefit claims of an employer's terminated employees, these contributions vary significantly from employer to employer and are not included in the analysis.

- Other industry-specific taxes are not included in the analysis and can be significant for certain taxpayers. Insurance premium tax, severance tax, utility gross receipts tax and other excise taxes are not included in the analysis but would influence investment decisions for businesses operating in certain industries.
- Non-tax costs are typically the most significant variable business cost and are not considered in this analysis. For example, in 2008, labor compensation was 30% of total US gross output, making it the most significant operating cost for most industries. Other operating costs such as utilities and freight costs to major suppliers can also influence location decisions. While this analysis identifies only state and local tax cost differences across states, non-tax cost differentials may cause a high tax location to be a more desirable investment location than a low tax location.

[4] Studies that use this approach and provide a more detailed description of the benefits of the hypothetical firm methodology include: Papke, James, and Leslie Papke. "Measuring Differential State-local Tax Liabilities and Their Implications for Business Investment Location." National Tax Journal, (1986): 357-366 and Fisher, Peter S and Alan H Peters. "Measuring tax and incentive competition: What is the best yardstick?" Regional Studies (1997); 31:751-764.



Results

The competitiveness analysis determines the combined state and tax liabilities for each type of new investment in each state: headquarters operations, research and development facilities, durable and non-durable manufacturing facilities and office and call center activities.

A key step in determining the competitiveness index is to combine the results for each specific type of facility into an overall result for each state. The combined index is calculated by weighting the tax burdens for each type of activity by the significance of each facility type in the overall mix of business facility investments over the past several years. These weights are calculated from Ernst & Young LLP's study of announced capital investments by companies investing in new or expanded facilities from December 2007 through September 2009.[5] The investment announcements include the projected number of new jobs and amount of capital investments related to new and expanded facilities in each state. Table 1 shows the distribution of announced jobs and capital investments by facility type. The overall tax burden calculations can be weighted by either the distribution of capital expenditures or the distribution of jobs associated with the investments.

Based on the financial profiles and major tax system characteristics described in the appendix and the shares of capital expenditures and jobs shown in Table 1, Table 2 presents the overall burden of major state and local taxes on investments in new or expanded facilities over a 30-year period for each state.

The competitiveness results are summarized by calculating an effective business tax rate for each state. The effective tax rate (ETR) is calculated as the percentage change in the rate-of-return over the 30-year period analyzed. For example, if state and local taxes reduce the before-tax rate of return from 15% to 13%, the effective tax rate is 13.3% (a two percentage point decrease divided by the 15% pre-tax rate of return). The results in the table reflect the average ETRs on hypothetical investments in five different types of facilities: headquarters, research and development, office/call center, durable manufacturing, and non-durable manufacturing. The ETRs for each type of investment are weighted by capital expenditures for each type in deriving the overall competitive index. (See the appendix for results weighted by employment rather than capital expenditures.) The states that are ranked highest in business tax competitiveness have the lowest overall ETRs.

[5]Observed capital investment and employment data as reported in the Ernst & Young LLP US Investment Monitor for various facility types.

Table 1. Distribution of capital investment and jobs in announced facilities, 2008 to 2009

Facility type	Capital expenditures	Jobs
Headquarters facility	6%	11%
Research and development facility	3%	5%
Office and call center facility	9%	26%
Durable manufacturing facility	40%	40%
Non-durable manufacturing facility	42%	18%

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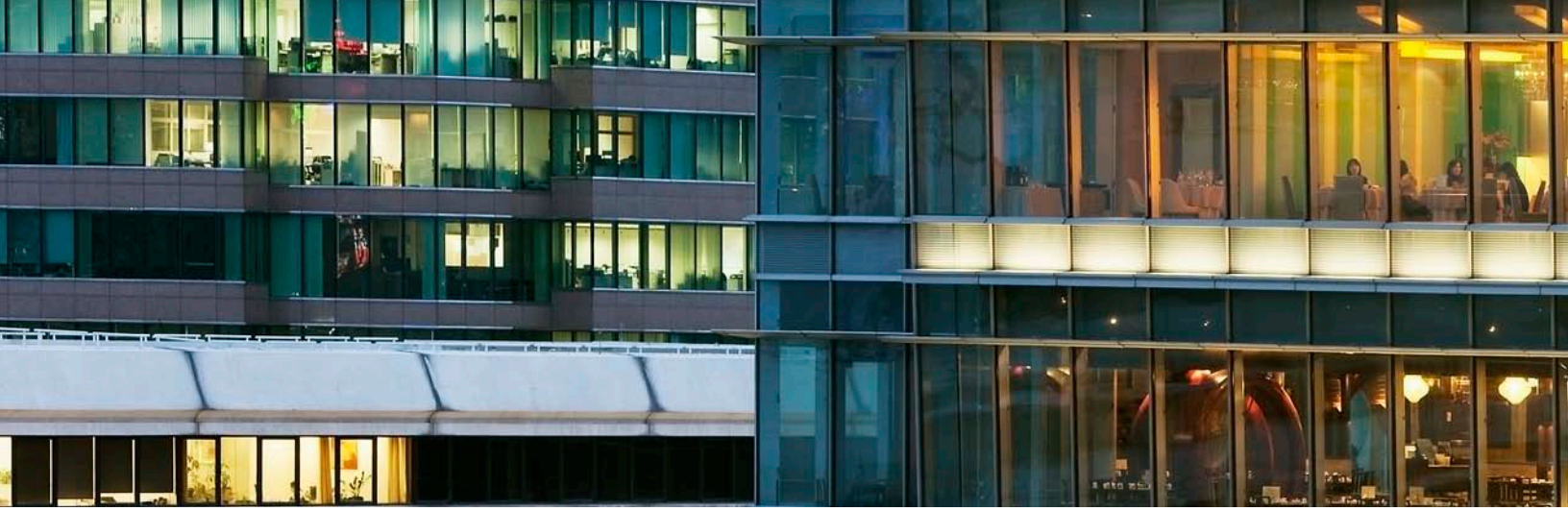
Table 2. State and Local Business Tax Competitiveness Index: Taxes on New Investment by Selected Industries

	Weighted by Capital Investment		Weighted by Jobs	
State	ETR	Rank	ETR	Rank
Maine	3.0%	1	4.3%	1
Oregon	3.8%	2	4.4%	2
Ohio	4.4%	3	5.6%	3
Wisconsin	4.5%	4	5.7%	4
Illinois	4.6%	5	6.0%	8
Virginia	5.4%	6	6.6%	10
New Hampshire	5.4%	7	5.9%	6
Delaware	5.7%	8	5.8%	5
Wyoming	5.8%	9	6.4%	9
Minnesota	6.0%	10	7.5%	13
Montana	6.1%	11	6.0%	7
Maryland	6.3%	12	8.7%	25
South Dakota	6.4%	13	7.1%	11
Iowa	6.4%	14	8.1%	18
Kentucky	6.5%	15	7.8%	15
Georgia	6.6%	16	7.9%	16
Utah	6.7%	17	8.0%	17
Colorado	6.8%	18	7.7%	14
Indiana	6.8%	19	8.3%	21
Texas	6.9%	20	8.2%	19
Pennsylvania	7.1%	21	8.3%	20
Missouri	7.1%	22	8.4%	24
New York	7.1%	23	8.9%	27
Michigan	7.2%	24	8.4%	22
Alaska	7.2%	25	7.2%	12
North Dakota	7.3%	26	8.4%	23
Florida	7.4%	27	8.7%	26
New Jersey	7.5%	28	9.2%	31
California	7.7%	29	10.0%	35
Idaho	7.7%	30	9.1%	30
Vermont	7.8%	31	9.0%	29
Massachusetts	8.2%	32	9.7%	34
Nevada	8.2%	33	8.9%	28
North Carolina	8.6%	34	10.2%	36
Oklahoma	8.8%	35	10.5%	38
Arkansas	8.9%	36	10.5%	39
South Carolina	8.9%	37	9.5%	33
Connecticut	8.9%	38	9.4%	32
Arizona	9.3%	39	11.0%	42
Washington	9.4%	40	12.4%	47
Nebraska	9.4%	41	10.2%	37
West Virginia	9.7%	42	10.9%	41
Alabama	9.7%	43	11.0%	44
Mississippi	10.2%	44	10.8%	40
Tennessee	10.3%	45	11.8%	45
Hawaii	10.8%	46	11.0%	43
Louisiana	11.1%	47	12.0%	46
Kansas	11.2%	48	12.5%	48
Rhode Island	11.5%	49	13.4%	49
District of Columbia	16.6%	50	16.7%	50
New Mexico	16.6%	51	17.9%	51
50-state mean	7.9%		9.1%	
50-state median	7.3%		8.7%	



The ETR for each of the hypothetical investments varies significantly by the type of facility. Weighting these results by capital investment, as shown in the left section of Table 2, places more importance on the effective tax rate on investments by capital intensive industries with the largest capital expenditures, such as manufacturing industries. The right section of Table 2, which weights the results by the number of jobs created by each facility type, presents an alternative view of the relative level of business tax burdens that puts more weight on the effect of state and local business taxes on labor intensive service activities.

As shown in Table 2, Maine's business tax structure imposes the smallest burden on new investment for the selected industries analyzed with an overall index of 3.0%, when weighted by capital investment. This relatively low burden is due to the following factors:

- Maine uses a single sales factor corporate income apportionment formula. While Maine's corporate tax rate is higher than average (8.93% in Maine compared to 6.7% nation-wide), Maine's favorable income apportionment regime more than offsets the rate differential for the hypothetical investments included in the competitiveness index.
- Maine has an average property tax rate. Maine's real property tax rate (in Portland) is 1.69% compared to a national average of 1.97%. Personal property tax rates in Maine are slightly above average at 1.77% compared to a national average of 1.65%, but new equipment is exempt from the property tax and any local property tax paid on qualified equipment is refunded through the Business Equipment Tax Reimbursement Program.
- Maine has no franchise tax.
- Maine's combined state and local sales tax rate is one of the lowest in the nation (5% compared to a national average of 6.2%)

Oregon's business tax structure imposes the second smallest burden on new investment for the selected industries analyzed, reducing the rate of return by an average 3.8% when weighted by capital investment. This relatively low state and local tax burden (effective tax rate) results from several factors:

- Oregon uses a single sales factor corporate income apportionment formula, meaning that the hypothetical investment in a new facility will have a very small impact on the amount of corporate income subject to tax in Oregon due to sales outside of Oregon.
- Oregon imposes no sales tax on business inputs. Two of the five facilities analyzed are service-oriented operations that do not generally qualify for manufacturing sales tax exemptions available in many states. Because many of the operating inputs purchased by these facilities are subject to state and local sales tax, Oregon's lack of sales tax is a significant benefit.
- While Portland, Oregon has a slightly higher than average tangible personal property tax (2.11% in Oregon compared to 1.65% nation-wide), it imposes a below average tax on real property (1.07% in Oregon compared to 1.97% nation-wide).
- Oregon imposes no franchise tax. For the headquarters location especially, franchise tax can be a significant tax expense because it is a tax on a taxpayer's net worth

[6]Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," State Tax Notes, May 30, 2008. The study was prepared for the Council on State Taxation. Combined reporting could produce higher corporate income taxes on the new capital investments, compared to separate filing, if combination increases the profits per dollar of factors attributable to the state. In this case, combined reporting states would have higher corporate tax burdens than calculated in the competitiveness index.

Ohio has the third lowest overall business effective tax rate. Ohio's high business competitiveness ranking reflects the major business tax reforms adopted in 2005 that substituted the modified gross receipts tax for corporate income and franchise taxes and eliminated business tangible personal property taxes. The modified gross receipts tax uses destination sales to determine Ohio tax liabilities and significantly lowers taxes on businesses making new instate investments. The remaining top-ten states in terms of business tax competitiveness all have ETRs less than or equal to 6%.

For the selected facility types, New Mexico's state and local business tax system imposes the greatest tax burden of any state, reducing the rate of return by an average 16.9%. This relatively high tax burden results from several factors:

- New Mexico uses an equally weighted corporate income apportionment formula. New Mexico's formula apportions to the state a share of national income equal to the average of the percentage of the taxpayer's nation-wide sales, payroll and property in the state. For the hypothetical facilities, this means that roughly two thirds of the additional income attributable to the new investment will be subject to tax in New Mexico. In addition, New Mexico's corporate tax rate is slightly above average (7.6% in New Mexico compared to a nation-wide average of 6.7%).
- New Mexico imposes a gross receipts tax on virtually all business activity. The tax is levied at a relatively high tax rate for a gross receipts tax (5.125% at the state level) plus a local tax comparable to retail sales taxes. However, unlike a retail sales tax, it applies to most services. While this tax is technically a liability of the seller, in practice it is passed forward to purchasers and is typically stated separately on invoices. Therefore, this analysis treats the tax as a sales tax with few exemptions, resulting in a significant tax burden for facilities that purchase a large amount of services and other inputs typically exempt from state and local sales taxes. In sharp contrast to New Mexico, Ohio, ranked the 4th most competitive state, imposes a gross receipts tax at a rate of 0.26%.
- New Mexico taxes both real and tangible personal property, although the property tax rate in Albuquerque is slightly below average.

The business tax competitiveness index shows the large difference in business tax burdens among the states. Based on the ETRs presented in Table 2, the average state and local business tax burden in the 10 most competitive states (5.0%) is only 42% as large as the average tax burdens for the 10 least competitive states (11.8%). The results also show that more than 20 states have business tax burdens that vary in the narrow range of 6% to 8%.

Results by facility type

Because of differing levels of profitability, capital intensity, and taxable input purchases, state and local business taxes affect each facility type differently. Table 3 shows the composition of the total tax burden on each facility type analyzed in this study.

As shown in Table 3, service facilities such as business support and research facilities pay more sales tax as a share of their total state and local tax burden than other types of facilities. This higher sales tax burden results from the lack of sales tax exemptions for most input purchases by service facilities compared to manufacturing facilities that generally receive sales tax exemptions for their purchases of inputs used in the production process.

In contrast, manufacturing industries pay significantly more property tax as a share of their total state and local tax burden than service industries. This higher-than-average property tax burden results from the higher average capital intensity of these facilities and their significant investments in personal property, which is often taxed at a higher property tax rate than real property.

Headquarters facilities generate the largest share of their tax liability from business income taxes due to their typically high profitability per dollar of receipts and assets. In contrast to other facility types, these headquarters facilities have generally low operating expenses and depreciable property relative to profits, reducing the significance of these other taxes on headquarters location decisions.

Conclusion

The Ernst & Young LLP/COST state business tax competitive index is a useful ranking for companies and policy-makers to assess the relative state and local tax burden on mobile business investment. The index includes all major business taxes, incorporating key features of the rates and tax bases, and weights the different taxes by their relative size. The index also focuses on five types of mobile corporate investments, which would be most likely to affect the location decisions of multistate and multinational businesses. The index distinguishes between destination and origin-based taxes, the latter of which affect the relative production costs of particular locations.

Table 3. Distribution of effective tax rates by facility type and tax type

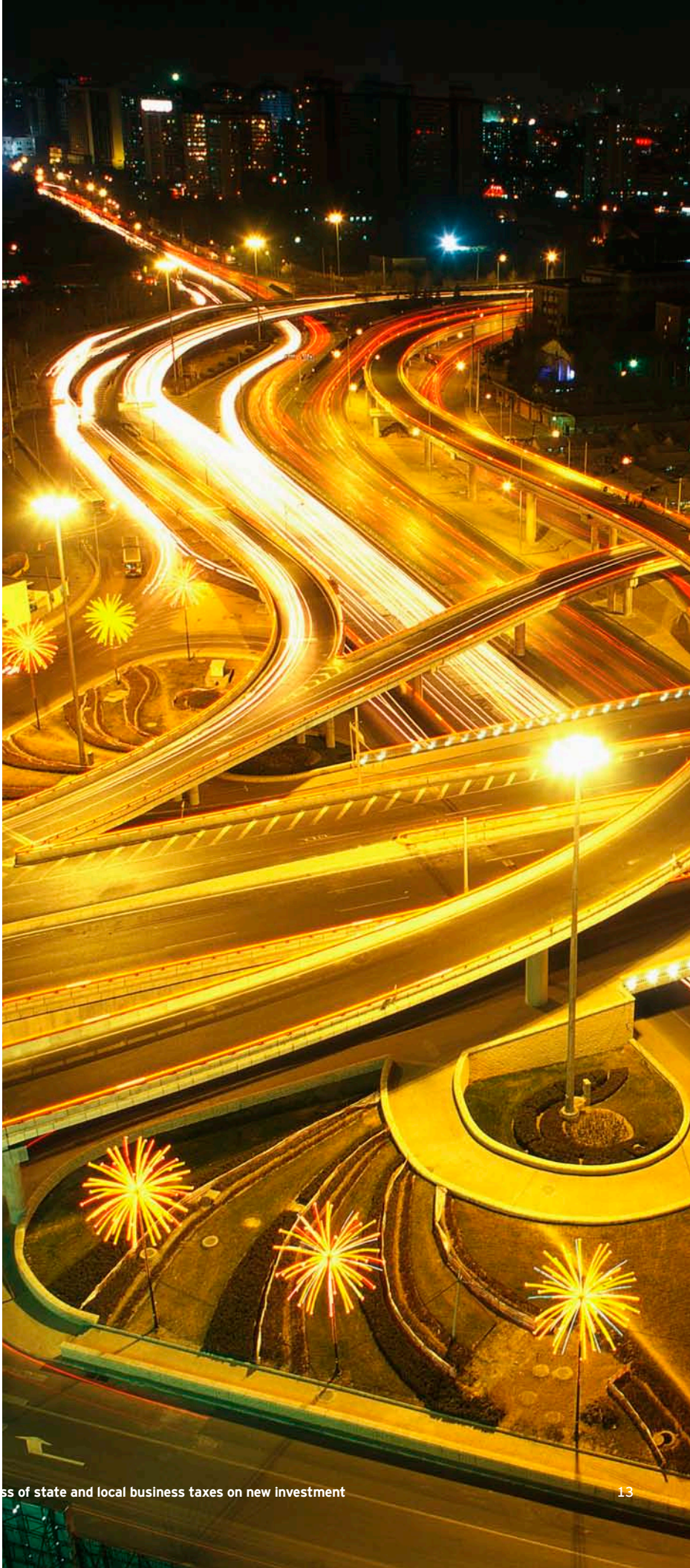
Tax type	Headquarters facility	Research and development facility	Office and call center facility	Durable manufacturing facility	Non-durable manufacturing facility
Sales tax	0.16%	4.20%	10.14%	3.31%	1.87%
Corporate/business taxes	2.51%	3.41%	3.65%	2.46%	2.42%
Property tax	0.12%	1.61%	0.81%	2.79%	2.19%
Total effective tax rate	2.79%	9.21%	14.61%	8.56%	6.48%

Amounts may not appear to sum due to rounding.

Any index or state ranking has certain limitations, and these are clearly spelled out in the report. Nonetheless, the new Ernst & Young LLP/COST state business tax competitiveness index can help companies narrow the number of states to do more thorough tax and non-tax location comparison. And the index provides government policy-makers and their staffs with an empirical-based, objective measure of the relative tax burden of state business taxes on mobile investments.

The report shows very different rankings than simple comparisons of statutory tax rates. As corporate tax departments know, the details of different taxes matter greatly and factors like apportionment formula weights can be more significant than statutory tax rates for certain taxpayers. The analysis also shows that non-income taxes such as the property and sales tax are often more important than state income tax in cross-state tax comparisons.

Ernst & Young LLP will continue to make refinements to the index in future releases. We hope the information is helpful, and a useful supplement to the other Ernst & Young LLP state tax publications, including the annual Ernst & Young LLP /COST 50-state business tax study, the annual U.S. Investment Monitor tracking the locations of new mobile capital investments, and the recent Ernst & Young LLP study analyzing the economic incidence of state business taxes.



Appendix

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Modeling methodology and assumptions

This appendix provides additional description of the modeling approach, assumptions and data used in the analysis.

Financial profile

The business tax competitiveness modeling begins with the development of a financial and operating profile for each hypothetical company. Financial profiles are developed for each hypothetical company (one per industry) using average balance sheet and income statement information for all firms in each industry from federal tax return information reported by the IRS in Statistics of Income Corporate Tax Reports. The federal corporate tax data includes business receipts, other income, depreciable and financial assets, equity and liabilities, cost of goods sold, and selected other operating expenses reported on federal corporate tax returns.

The federal corporate tax data is then supplemented with detailed data from the Bureau of Economic Analysis (BEA) describing the distribution of assets and operating expenses by industry. The distribution of assets, from BEA's fixed asset data, shows the net value (after depreciation) of each type of structure and equipment owned by each industry. Similarly, detailed operating expense information from the BEA's input-output tables is used to disaggregate "other deductions" reported on the federal tax return into detailed operating expense categories.

The assumed financial profile for each hypothetical investment is summarized in Table A-1. The table shows the level of key financial metrics per dollar of investment. The financial profile of the investments influences the calculation of the tax bases and the significance of each tax type in the overall business tax liability. For example, firms with high levels of depreciable assets and land per dollar of business receipts and income will be more affected by property taxes, while firms that have high levels of profit per dollar of assets or receipts will be more affected by corporate income taxes.

The financial profiles are projected for a 30-year period. This multiyear perspective recognizes differences in the timing of tax provisions, such as depreciation allowances and scheduled, current-law changes in tax rates and other tax features. For example, sales taxes on investments occur initially and at intervals when investment is replaced over time. In contrast, property and corporate income taxes are an annual expense that the business will incur in each of the 30 years. This multiyear perspective also enables the calculation of the present value of the tax stream, recognizing that taxes that are paid sooner have more of a negative impact on the investor's return from the investment.

An important note is that while the analysis attempts to isolate the taxes that would result from an investment in specific types of facilities, most facilities will be operated as part of a larger entity involved in many different activities. For example, the financial profile for the research and development facility is based on tax return information and economic data for the research industry (NAICS 5417), but many research and development facilities are operated by companies in the manufacturing sector. Because the IRS does not report financial data by facility or operating unit, this analysis is based on industry-level information that most closely approximates the activities occurring at each of the hypothetical facility types.[7]

[7] This assumption has limited impact on the estimates of the sales taxes and property taxes because these taxes are, in most cases, determined by the type and use of property rather than by the type of purchaser. However, corporate income taxes may be affected if, for example, the taxpayer can qualify for special apportionment or other preferential treatment because of activities conducted by another part of the business.

Table A-1. High-level financial profile of hypothetical investments (amounts shown as a percentage of invested assets)

	Headquarters facility	Research and development facility	Office and call center facility	Non-durable manufacturing facility	Durable manufacturing facility
Assets and liabilities					
Depreciable assets and land	0.7%	11.2%	13.8%	9.3%	13.9%
Cash and other current assets	25.3	27.7	39.1	41.2	21.3
Investments and intangibles	68.6	53.4	42.8	44.9	57.5
Other assets	5.4	7.7	4.3	4.7	7.3
Total assets	100.0%	100.0%	100.0%	100.0%	100.0%
Equity	72.4	47.4	38.1	31.6	35.9
Debt and other liabilities	27.6	52.6	61.9	68.4	64.1
Total equity and liabilities	100.0%	100.0%	100.0%	100.0%	100.0%
Receipts and deductions					
Business receipts	0.4%	49.8%	242.1%	53.8%	101.1%
Other receipts	11.2	11.2	7.3	3.4	6.1
Total receipts	11.7%	61.0%	249.4%	57.2%	107.2%
Cost of goods sold	0.1%	14.7%	112.7%	36.7%	75.7%
Interest	1.2	1.3	2.3	1.6	3.1
Depreciation*	0.1	2.2	2.5	0.9	1.7
Other expenses	1.7	33.3	114.9	13.2	21.1
Total deductions	3.1%	51.4%	232.4%	52.3%	101.6%
Net income	8.6	9.6	17.0	4.9	5.6
Note: Total labor cost**	0.5	26.9	97.4	7.7	18.2

Source: Internal Revenue Service Statistics of Income, Corporate Source Book, 2006.

*Includes depreciation, depletion and amortization.

**Includes imputed labor embedded in cost of goods sold deduction, salaries and wages, compensation of officers, employee benefit programs, pension and profit-sharing.

Amounts may not appear to sum due to rounding.

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Modeling assumptions

The modeling approach used in this analysis requires certain assumptions about the distribution of nation-wide sales, ongoing replacement of depreciating assets and other operational and financial characteristics. These tax features can have a significant impact, for example, on comparative corporate income tax liabilities.

There are a number of key assumptions related to the corporate income tax. Nation-wide corporate income of a multistate company is apportioned to each state based partially or wholly on the share of the company's nation-wide sales attributable to the state. A state's share of sales from a new or expansion investment will vary by type of activity and sales sourcing rules. This analysis makes the assumption that 5% of a manufacturing company's additional sales resulting from the investment will be sold in the state where the facility investment is located. The other 95% of sales are assumed to be sold in other states. For activities primarily involving the sales of services, two different percentages are used for in-state sales, 20% in states with market based sourcing and 30% in states with cost of performance. The analysis assumes that the share of in-state sales is the same in every state to maintain comparability between the results for each state.[8]

While the analysis assumes that only a portion of the sales from the new facility is in-state, the estimates assume that all of the payroll and property related to the expansion are in-state. In other words, by locating the expansion in a specific state, the analysis assumes that all of the additional employees and property are also located in the state.

Another important assumption relates to depreciating property. The analysis assumes that as equipment and structures are used and depreciated, they are replaced. The result of this assumption is that the level of assets and property potentially subject to the property tax is constant over the 30-year time horizon.

Finally, the analysis assumes that the investment is an expansion by a company that already has a significant presence in the state, is profitable and would incur additional state corporate income tax liability at the highest marginal tax rate. This is generally consistent with the operations of a large, multistate taxpayer that has operations in a number of states.

State and local tax system features

The current-law statutory tax components, including tax rates and tax base calculations, for each of the major state and local business taxes in each state, are incorporated into the analysis. State and local taxes included in this report are: corporate income taxes, corporate franchise taxes, sales and use taxes on business input purchases, gross receipts taxes and property taxes. Sales and use taxes collected from customers by the representative firm are not included as business taxes. The BTCM calculations include depreciation allowances and apportionment formulas for each corporate expansion. Except where noted, tax rates and other tax system characteristics reflect statewide averages that combine state and local tax rates, such as sales taxes or average over geographic locations, such as property taxes.

[8]The results are sensitive to changes in this assumption. If the assumed percentage of sales in-state is increased to 20% for manufacturers, 30% for service providers using market sourcing and 40% for service providers using cost of performance, states with high corporate tax rates and single sales factor apportionment formulas are less competitive. If all of the marginal sales are assumed to be made to in-state customers, some states with high corporate tax rates and single sales factor apportionment become significantly less competitive. Oregon, which is ranked second most competitive in our base case, moves to least competitive if all of the sales from the hypothetical facilities are assumed to be sold in the state.

Corporate income tax and other business entity taxes

Corporate income taxes and other types of general business entity taxes are in place in 46 states and the District of Columbia. In most states, the business entity tax is based on corporate income, but a recent trend has been the movement toward taxes based on modified gross receipts. Table A-2 shows the basic features of each state's general business entity tax, including the general rate, type of tax base, special apportionment allowed for select industries and apportionment formula weighting. As discussed below, each of these factors is significant in determining the overall burden of the business entity tax on the hypothetical firms making investments in the state.

Tax rate: In states taxing corporate income, the rate ranges from 4.6% in Colorado to 12.0% in Iowa. In addition, Ohio's commercial activity tax based on gross receipts has a rate of 0.26%, the Texas margin tax on modified gross receipts has a general rate of 1.0%, and the Michigan business tax has a permanent rate of 0.8% on modified gross receipts (in addition to a 4.94% tax on corporate net income). New Hampshire levies its business enterprise tax on value-added at 0.75% as a form of minimum business tax. Washington imposes its business and occupation tax on gross income at varying rates. Note that since the analysis was completed, Illinois increased its total corporate tax rate (base rate plus personal property replacement) from 7.3% to 9.5 until 2015, when it will drop to 7.75% through 2025. This change is not reflected in the results because it was not current law in 2009. However, due to Illinois' single sales factor apportionment formula and the assumptions used in this analysis about the percentage of in-state sales, the impact of this change on Illinois' ranking is relatively minor.

Tax base: Corporate net income is the most common business entity tax base, but as noted above, there has been a movement over the past several years to broader tax bases based on gross receipts. Among the states that tax corporate income, most use similar definitions of net income with most beginning with federal income definitions with certain state adjustments.

Apportionment formula: The state corporate income apportionment formula rivals the tax rate as the most important feature of state business entity tax systems in this analysis because of the assumption that a relatively small portion of increased sales from the facility is sold to in-state customers. In order for multistate corporations that earn income across the United States to be taxed by each state, they must determine what share of their national income is attributable to each state. The method used is described as formulary apportionment. The typical apportionment formula uses a corporation's sales, payroll and property located in a state divided by those same factors everywhere to determine what percentage of its nation-wide income is attributable to the state.

Many states use what is called a double-weighted sales factor apportionment formula. This method of apportionment applies a weight of 50% to the sales ratio (in-state sales divided by everywhere sales). This formula simultaneously reduces the importance of payroll and property in determining a state's tax base. The significance of this factor weighting is that the location of sales is twice as important as the other factors.

An increasing number of states have moved to apportionment formulas based entirely on the sales factor. These states, which are described as having "single sales factor" income apportionment formulas, tax a share of US income equal to the state's share of the taxpayer's US sales. As noted in the results section, corporate income apportionment formulas significantly impact the tax burden on an investment by a firm exporting a large share of its output from the state.

The sales factor is also affected by the sourcing rules used to determine in which state a sale occurs. For manufacturing and retail companies that sell tangible property to their customers, the sales are generally sourced to the state where goods are shipped (referred to as "destination sales"). For companies selling services, the sales are sourced to the location where the service is used (referred to as "market sourcing") or the location where the service is provided (referred to "cost of performance sourcing"). As discussed above, the competitiveness analysis assigns different in-state sales percentages to the different types of activities included in the analysis. For states with single sales factor apportionment of corporate income, differences in the share of in-state sales can have a large impact on the overall apportionment formula for different types of activities.

Sales tax

Forty-seven states and the District of Columbia levy state-level sales taxes, with an additional 34 states levying local sales taxes. The sales taxes included in the competitiveness index are those paid by businesses on taxable input purchases, including tangible property and services.

Tax rate: Sales tax rates vary significantly across states. (See Table A-3.) The combined state and local sales tax rate averages 6.2%, ranging from 4.0% in Hawaii to 10.6% in California. The local tax rate reflects the statewide average local tax rate, which was estimated using the ratio of local sales tax collections to state sales tax collections for each state (from the U.S. Census Bureau), multiplied by the state sales tax. For example, if a state with a 4% state tax rate had local tax collections that were 50% of state tax collections, the local tax rate is assumed to equal 2% (50% of the state rate).

Tax base: The definition of the state sales tax base can significantly affect the overall level of sales tax resulting from a new investment in a state over the life of that investment. States differ in the way in which they tax purchases of capital equipment and the construction of buildings. In many states, the purchase of equipment or construction of structures that will be used in a production process is exempt from tax or subject to a significantly reduced tax rate. Similarly, during the operating life of a facility, certain exemptions may be given for purchases of utilities and purchased materials that are consumed in a manufacturing process. These differences in the state sales tax base are incorporated into the analysis and contribute to significant variations in the total sales tax burden for the hypothetical investments analyzed in this report.

Property tax

Property taxes are levied by both state and local governments. As with the other major tax types, the tax rate and tax base are equally important factors in determining the overall tax burden for the hypothetical investments analyzed. Due to the general lack of centralized local property tax data, the BTCM uses property tax rates for the largest city in each state. While the rate in the largest city is generally indicative of local governments' reliance on the property tax as a source of revenue, it may diverge significantly from the average in a state.

Tax rate: Average real effective property tax rates vary across the major metropolitan areas included in this study from 0.65% in Virginia Beach, Virginia to 4.35% in Des Moines, Iowa. (See Table A-4.) Similarly, effective tangible personal property rates vary significantly across those states that tax personal property, from 0.67% in Cheyenne, Wyoming to 5.67% in Baltimore City, Maryland. The effective property tax rates reflect the statutory property tax rate multiplied by the assessment ratio for each type of property. For example, a jurisdiction that assesses property at 50% of market value and has a tax rate of 2% would have a 1% effective tax rate on property (50% of 2%).

Tax base: The major types of property subject to local taxation are real and personal property. Real property, consisting of land and structures, is taxed in all states. In addition, 38 states and the District of Columbia also tax tangible personal property, while 12 states exempt tangible personal property completely. For the hypothetical investment analyzed in this report, tangible personal property consists of manufacturing equipment; furniture, fixtures, non-manufacturing equipment; and motor vehicles. Of the states that tax tangible personal property, four states exempt manufacturing equipment from the tax base, significantly reducing the property tax burden for the manufacturing investments analyzed.

Table A-2. State Business Entity Tax Characteristics, 2009

State	Top marginal rate	Apportionment weighting	Special apportionment for selected industries	Business income tax base
Alabama	6.50%	Equally weighted	No	Corporate income
Alaska	9.40%	Equally weighted	No	Corporate income
Arizona	6.97%	Double weighted sales	No	Corporate income
Arkansas	6.50%	Double weighted sales	No	Corporate income
California	8.84%	Double weighted sales	No	Corporate income
Colorado	4.63%	Single sales factor	No	Corporate income
Connecticut	7.50%	Single sales factor	Yes	Corporate income
Delaware	8.70%	Equally weighted	No	Corporate income
District of Columbia	9.98%	Equally weighted	No	Corporate income
Florida	5.50%	Double weighted sales	No	Corporate income
Georgia	6.00%	Single sales factor	Yes	Corporate income
Hawaii	6.40%	Equally weighted	No	Corporate income
Idaho	7.60%	Double weighted sales	Yes	Corporate income
Illinois	7.30%	Single sales factor	No	Corporate income
Indiana	8.50%	80% Weighted sales	No	Corporate income
Iowa	12.00%	Single sales factor	No	Corporate income
Kansas	7.05%	Equally weighted	Yes	Corporate income
Kentucky	6.00%	Double weighted sales	No	Corporate income
Louisiana	8.00%	Equally weighted	Yes	Corporate income
Maine	8.93%	Single sales factor	No	Corporate income
Maryland	8.25%	Double weighted sales	Yes	Corporate income
Massachusetts	9.50%	Double weighted sales	Yes	Corporate income
Michigan	4.95%	Single sales factor	No	Corporate income and gross receipts
Minnesota	9.80%	84% weighted sales	No	Corporate income
Mississippi	5.00%	Single sales factor	Yes	Corporate income
Missouri	6.25%	Single sales factor	No	Corporate income
Montana	6.75%	Equally weighted	No	Corporate income
Nebraska	7.81%	Single sales factor	No	Corporate income
Nevada	–	–	–	–
New Hampshire	8.50%	Double weighted sales	No	Corporate income and value added
New Jersey	9.00%	Double weighted sales	No	Corporate income
New Mexico	7.60%	Equally weighted	Yes	Corporate income
New York	7.10%	Single sales factor	No	Corporate income

State	Top marginal rate	Apportionment weighting	Special apportionment for selected industries	Business income tax base
North Carolina	7.11%	Double weighted sales	No	Corporate income
North Dakota	6.40%	Equally weighted	No	Corporate income
Ohio	0.26%	Single sales factor	No	Gross receipts
Oklahoma	6.00%	Equally weighted	No	Corporate income
Oregon	7.90%	Single sales factor	No	Corporate income
Pennsylvania	9.99%	83% weighted sales	No	Corporate income
Rhode Island	9.00%	Equally weighted	No	Corporate income
South Carolina	5.00%	Single sales factor	Yes	Corporate income
South Dakota	–	–	–	–
Tennessee	6.50%	Double weighted sales	No	Corporate income
Texas	1.00%	Single sales factor	No	Modified gross receipts
Utah	5.00%	Double weighted sales	No	Corporate income
Vermont	8.50%	Double weighted sales	No	Corporate income
Virginia	6.00%	Double weighted sales	Yes	Corporate income
Washington	Multiple	–	–	Gross receipts tax
West Virginia	8.50%	Double weighted sales	No	Corporate income
Wisconsin	7.90%	Single sales factor	No	Corporate income
Wyoming	–	–	–	–

Notes: AZ has an election for 80% sales weight; CA has adopted optional 100% sales factor apportionment as of 2011 – this analysis assumes each firm uses 100% sales apportionment; CT 50% weighted sales, selected industries; KS manufacturers may use 100% sales factor and selected industries may use 2-factor formula (prop. and sales); LA allows 100% sales weight for manufacturers and 2-factor formula (payroll and sales) for services; MD manufacturers must use 100% sales weight; MA 100% sales weight formula available for manufacturers; MI taxpayers pay tax on both bases; MS has alternative formulas for manufacturers; MO 100% sales weight is elective (standard is equally weighted); NM manufacturers may use 50% sales weight; SC is phasing in the 100% sales factor weight for manufacturers (allows 60% of tax reduction in 2009); UT's 50% sales weight is elective (standard is equally weighted)

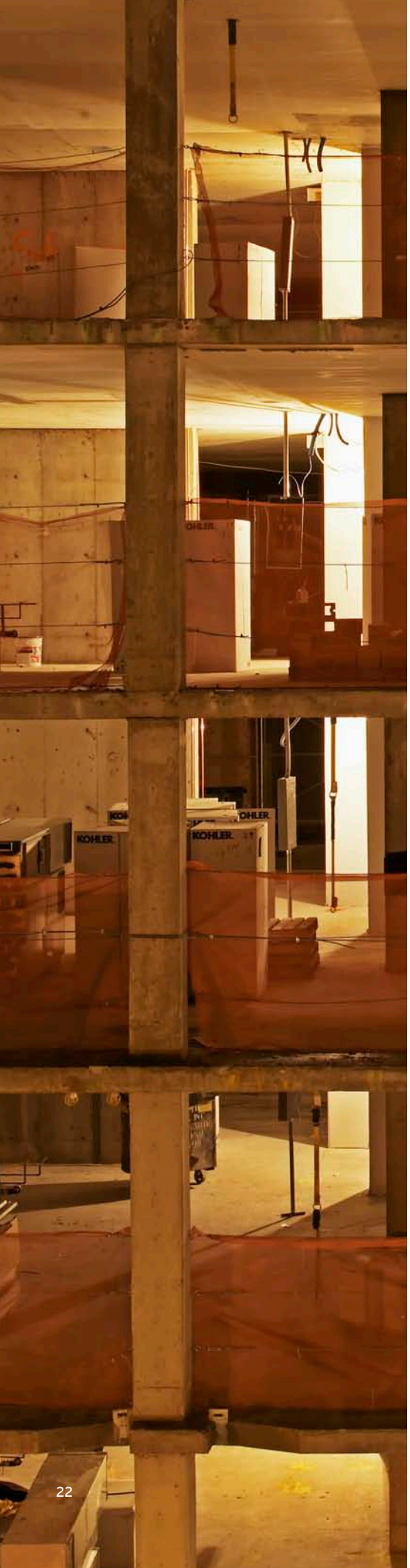

Table A-3. State Sales Tax Characteristics, 2009

State	State rate	Local rate	Total state and local tax rate
Alabama	4.0%	3.1%	7.1%
Alaska	0.0%	0.0%	0.0%
Arizona	5.6%	2.3%	7.9%
Arkansas	6.0%	1.8%	7.8%
California	8.3%	2.3%	10.6%
Colorado	2.9%	3.8%	6.7%
Connecticut	6.0%	0.0%	6.0%
Delaware	0.0%	0.0%	0.0%
District of Columbia	6.0%	0.0%	6.0%
Florida	6.0%	0.4%	6.4%
Georgia	4.0%	2.7%	6.7%
Hawaii	4.0%	0.0%	4.0%
Idaho	6.0%	0.0%	6.0%
Illinois	6.3%	1.1%	7.3%
Indiana	7.0%	0.0%	7.0%
Iowa	6.0%	1.8%	7.8%
Kansas	5.3%	1.8%	7.1%
Kentucky	6.0%	0.0%	6.0%
Louisiana	4.0%	4.1%	8.1%
Maine	5.0%	0.0%	5.0%
Maryland	6.0%	0.0%	6.0%
Massachusetts	6.3%	0.0%	6.3%
Michigan	6.0%	0.0%	6.0%
Minnesota	6.9%	0.1%	7.0%
Mississippi	7.0%	0.0%	7.0%
Missouri	4.2%	2.3%	6.5%
Montana	0.0%	0.0%	0.0%
Nebraska	5.5%	0.9%	6.4%
Nevada	6.9%	0.7%	7.5%
New Hampshire	0.0%	0.0%	0.0%
New Jersey	7.0%	0.0%	7.0%
New Mexico	5.0%	1.9%	6.9%
New York	4.0%	4.1%	8.1%
North Carolina	5.8%	2.1%	7.9%

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State	State rate	Local rate	Total state and local tax rate
North Dakota	5.0%	0.9%	5.9%
Ohio	5.5%	1.2%	6.7%
Oklahoma	4.5%	3.3%	7.8%
Oregon	0.0%	0.0%	0.0%
Pennsylvania	6.0%	0.1%	6.1%
Rhode Island	7.0%	0.0%	7.0%
South Carolina	6.0%	0.2%	6.2%
South Dakota	4.0%	1.5%	5.5%
Tennessee	7.0%	1.7%	8.7%
Texas	6.3%	1.5%	7.7%
Utah	4.7%	1.5%	6.2%
Vermont	6.0%	0.1%	6.1%
Virginia	4.0%	1.0%	5.0%
Washington	6.5%	1.3%	7.8%
West Virginia	6.0%	0.0%	6.0%
Wisconsin	5.0%	0.3%	5.3%
Wyoming	4.0%	1.3%	5.3%

Source: RIA Checkpoint and CCH State Tax Reporters

Table A-4. Effective Property Tax Rates, 2009

State	Commercial structures	Industrial structures	Commercial equipment	Other industrial machinery and equipment
Alabama	1.37%	1.37%	1.39%	1.39%
Alaska	1.46%	1.46%	0.96%	0.96%
Arizona	1.95%	1.95%	2.35%	2.38%
Arkansas	1.38%	1.38%	1.41%	1.41%
California	1.22%	1.22%	1.22%	1.22%
Colorado	1.90%	1.90%	1.94%	1.94%
Connecticut	2.71%	2.71%	2.71%	1.08%
Delaware	0.87%	0.87%	0.00%	0.00%
District of Columbia	1.73%	1.73%	3.25%	3.37%
Florida	1.56%	1.56%	1.65%	1.66%
Georgia	1.62%	1.62%	1.77%	1.77%
Hawaii	1.06%	1.21%	0.00%	0.00%
Idaho	1.33%	1.33%	1.44%	1.44%
Illinois	2.44%	2.83%	0.00%	0.00%
Indiana	2.60%	2.71%	2.75%	2.75%
Iowa	4.35%	4.35%	0.00%	0.00%
Kansas	2.76%	2.76%	3.01%	3.01%
Kentucky	1.14%	1.14%	1.81%	0.15%
Louisiana	1.98%	1.98%	2.13%	2.13%
Maine*	1.69%	1.69%	0.00%	0.00%
Maryland	2.02%	2.02%	5.67%	0.00%
Massachusetts	2.30%	2.30%	2.71%	0.00%
Michigan*	4.12%	4.15%	3.55%	1.92%
Minnesota	3.35%	3.35%	0.00%	0.00%
Mississippi	2.41%	2.41%	2.56%	2.56%
Missouri	3.02%	3.02%	2.64%	2.64%
Montana	1.29%	1.29%	1.72%	1.72%
Nebraska	1.97%	1.97%	2.05%	2.05%
Nevada	1.11%	1.11%	1.14%	1.14%
New Hampshire	1.83%	1.83%	0.00%	0.00%
New Jersey	1.67%	1.67%	0.00%	0.00%
New Mexico	1.44%	1.44%	1.55%	1.55%
New York	3.88%	3.88%	0.00%	0.00%

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State	Commercial structures	Industrial structures	Commercial equipment	Other industrial machinery and equipment
North Carolina	1.08%	1.08%	1.30%	1.30%
North Dakota	2.03%	2.03%	0.00%	0.00%
Ohio	2.20%	2.22%	0.00%	0.00%
Oklahoma	1.25%	1.25%	1.56%	1.56%
Oregon	1.07%	1.07%	2.11%	2.11%
Pennsylvania	4.12%	4.12%	0.00%	0.00%
Rhode Island	2.57%	2.57%	5.36%	0.00%
South Carolina	1.73%	3.30%	4.75%	4.75%
South Dakota	1.46%	1.46%	0.00%	0.00%
Tennessee	2.89%	2.89%	2.16%	2.16%
Texas	2.36%	2.52%	2.54%	2.52%
Utah	1.36%	1.36%	1.38%	1.38%
Vermont	2.08%	2.08%	0.85%	0.85%
Virginia	0.65%	0.65%	1.48%	0.33%
Washington	0.71%	0.71%	0.78%	0.78%
West Virginia	1.67%	1.67%	1.67%	1.67%
Wisconsin	2.27%	2.27%	2.27%	0.00%
Wyoming	0.65%	0.78%	0.67%	0.82%

Source: 50-State Property Tax Comparison Study prepared cooperatively by Member States of the National Taxpayers Conference, June 2009

Note: some states allow an exemption for new machinery and equipment. These states are shown as having a 0.0% rate on equipment.

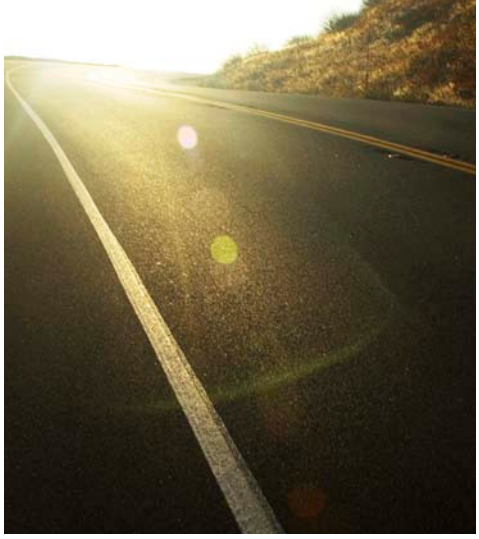
*adjusted by the amount of credit available for property taxes paid

Franchise tax

State franchise taxes are typically levied on the net worth of a company, although some states have adopted alternative bases that include the value of property held in the state. As shown in Table A-5, only 20 states levy a franchise tax, with most taxes levied on the value of capital stock (the sum of stockholder equity, paid-in capital, and retained earnings). Because of the large size of the tax base, the average franchise tax rate is very low, 0.07%, and ranges from 0.01% in Delaware to 0.48% in West Virginia.

Table A-5. State Franchise Tax Characteristics, 2009

State	Rate	Apportionment weighting	Franchise tax base
Alabama	0.18%	Equally weighted	Capital stock
Alaska	–	-	-
Arizona	–	-	-
Arkansas	0.30%	Equally weighted	Capital stock
California	–	-	-
Colorado	–	-	-
Connecticut	0.31%	100% property	Capital stock
Delaware	0.01%	Equally weighted	Capital stock
District of Columbia	–	-	-
Florida	–	-	-
Georgia	0.05%	50% weighted sales	Capital stock
Hawaii	–	-	-
Idaho	–	-	-
Illinois	0.10%	50% weighted sales	Capital stock
Indiana	–	-	-
Iowa	–	-	-
Kansas	0.06%	Equally weighted	Capital stock
Kentucky	–	-	-
Louisiana	0.30%	50% weighted sales	Capital stock
Maine	–	-	-
Maryland	–	-	-
Massachusetts	0.26%	Equally weighted	Capital stock
Michigan	–	-	-
Minnesota	–	-	-
Mississippi	0.25%	50% weighted sales	Capital stock
Missouri	0.03%	100% weighted property	Capital stock
Montana	–	-	-
Nebraska	0.04%	100% weighted property	Capital stock
Nevada	–	-	-
New Hampshire	–	-	-



State	Rate	Apportionment weighting	Franchise tax base
New Jersey	–	-	-
New Mexico	–	-	-
New York	0.15%	Equally weighted	Capital stock
North Carolina	0.15%	Equally weighted	Capital stock
North Dakota	–	-	-
Ohio	–	-	-
Oklahoma	0.13%	50% weighted sales	Capital stock
Oregon	–	-	-
Pennsylvania	0.29%	Equally weighted	Capital stock
Rhode Island	0.03%	Equally weighted	Capital stock
South Carolina	0.10%	Equally weighted	Capital stock
South Dakota	–	-	-
Tennessee	0.25%	Equally weighted	Capital stock
Texas	–	-	-
Utah	–	-	-
Vermont	–	-	-
Virginia	–	-	-
Washington	–	-	-
West Virginia	0.48%	50% weighted sales	Capital stock
Wisconsin	–	-	-
Wyoming	–	-	-

Source: RIA All States Tax Handbook

Notes

Ernst & Young

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About Ernst & Young
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Greater Louisville Inc.

Greater Louisville Inc.

Fiscal Policy & Budget Reform Principles

Kentucky's revenue and expenditure policies should be aligned to promote growth and business investment while providing the resources to meet the state's necessary obligations. Spending at the state level should be prioritized to reflect investment in Kentucky's future competitiveness. These priorities should start with a commitment to adequate funding for education at all levels and include a sustainable approach to meeting the state's infrastructure needs.

GLI believes the following principles should be followed in this process:

- Revenue generation should not place a disproportionate burden on businesses – as a whole or by size or sector – and *must* be coupled with spending reforms, including:
    - Developing a sustainable system for state employee benefits, including health and retirement.
    - Reducing the fixed costs of rapidly-expanding budget areas, including Medicaid and corrections.
    - Streamlining government services, including consideration of consolidation and privatization.
    - Aligning and redeploying current state resources to priority investment areas, such as education and economic development.

- Kentucky's tax code should:
    - Encourage investment and business growth;
    - Be attractive to knowledge-economy employers and their employees;
    - Decrease the state's over-reliance on personal income tax for revenue;
    - Provide a competitive advantage in attracting business and talent;
    - Provide more local revenue options for specific community development projects, which are limited in scope and term, and approved by local referendum;
    - Be simplified for ease of compliance and to reduce the cost of administration;
    - Generate revenue sufficient to meet the state's necessary obligations and investment needs.
    - Take into account the interplay between state and local taxation.

Adopted by Executive Committee Approval, November 2010

KENTUCKY YOUTH ADVOCATES

Fact Sheet

The Truth about State Earned Income Tax Credits

A strong Kentucky economy requires strong local economies, and local economies depend on stable, working families. You've been hearing a lot about what some people say a state Earned Income Tax Credit (EITC) would mean for Kentucky. Here's the truth: a state EITC is a proven way to increase work participation, generate local business and pull families from poverty to prosperity.

The Truth about EITC Goals

State EITCs have three goals:

- **Make our tax system more fair by offsetting the higher taxes that low-income workers pay:** Kentuckians making an average of $21,700 pay a larger share of their income in taxes than those making an average of $957,500—ten cents on the dollar compared to six cents on the dollar—when sales and excise, property, and income taxes are all taken into account. A state EITC would help working Kentuckians keep more of their hard-earned money and reduce inequities in the tax system.
- **Supplement earnings**: The EITC helps families cover the costs of basic needs. Many working parents earn low wages. They don't earn enough to meet their daily living expenses, much less save for things like increasing their education. They tend to use the refunds on housing, groceries, childcare, transportation and health care costs. Because they spend their refunds locally, the EITC helps local businesses.
- **Encourage and reward work**: The EITC has also been shown to help more parents, particularly single mothers, move into the workforce. State EITCs contribute to even higher increases in workforce participation than does the federal EITC alone. Research shows that over time these parents move into better jobs, and that most taxpayers only claim the EITC for a few years.

The Truth about Simplicity of Calculation

It's easy to calculate a state EITC—you just take a set percentage of the federal EITC. It takes two lines on the tax form. While the federal EITC may be complex, Kentucky does not need to administer it.

The Truth about Error Rates: Concerns about the EITC error rate are overstated

- The Treasury report is about the ***error*** rate, **not fraud.** The vast majority of erroneous payments are because the federal EITC is complicated, and tax filers have difficulty determining if they qualify, or because the payments were not adequately documented.
- **There is good reason to think that the error rate has been significantly overstated** due to methodological flaws in the studies. For example, a National Taxpayer Advocate study found that nearly half of the EITC claims assessed as overpayments in audits were reversed on appeal.
- The IRS **error estimate is based on old data** (from 2001). Because of legislative and IRS procedural changes, there is good reason to believe that the current error rate may be much lower. The IRS is conducting a new study of error rates, expected in 2012.
- **Since 2001, the IRS has taken and continues to take steps to reduce the error rate:**
    - The IRS now screens the Social Security numbers of both the parent and child to confirm the taxpayer's relationship to the child and checks the National Case Registry of child support cases to determine whether the parent has custody.

- This year, for the first time, the **IRS will regulate tax preparers**, which the IRS believes will reduce improper payments. (Two-thirds of EITC filers use a tax preparer.)
- The IRS conducts about **500,000 EITC audits** each year to identify erroneous claims.
- **The IRS trains and certifies Volunteer Income Tax Assistance (VITA) preparers.**
- The **IRS works with state revenue departments** to improve compliance with state and federal EITCs. (See http://www.cbpp.org/cms/?fa=view&id=3445 for more information)

Tax Credits are efficient ways to support Kentucky families

Using the tax code and tax credits is an efficient, low-cost way to help families work more and make ends meet. That's why Kentucky provides tax credits and tax deductions to everyone from corporations to homeowners. While a good argument can be made that every tax credit and deduction should be regularly reviewed so that only the effective ones continue, the tax code is still the most cost-efficient and effective way to administer this credit. Additionally, the costs of the state EITC are predictable. Kentucky would be able to make valid budget decisions, just as it does with the homeowner's mortgage deduction or corporate tax credits, and adjust them if needed to balance the budget.

Claiming the Kentucky EITC would be easy for low-income Kentuckians who are eligible

While some Kentuckians with low income levels would have to file a state income tax return for the first time, this would not be burdensome. They already need to file federal tax forms to claim the federal EITC, and it's very easy once you've filed your federal taxes to file and claim the state credit, since it is simply calculated as a percentage of the federal credit. In addition, VITA [volunteer income tax assistance] sites can assist low-income filers to help them claim it accurately and free of charge.

The federal EITC changes infrequently and Kentucky can decide whether to accept those changes separately

The federal EITC has changed only twice since 2001. Most states choose to follow the federal tax code, but several states have chosen not to follow those expansions; for example, in 2010, Virginia chose not to follow the 2009 expansion at first, but then chose to adopt it in both 2011 and 2012.

Tax policy rarely affects decisions on where to live

People choose where they will live based on whether they can find affordable housing they like, where they can find good schools or child care, and where their work, family and friends are located. Research shows that people don't move to reduce their taxes and there is no reason they would move to increase their tax refunds.[1] In addition, even for those who could keep their current jobs and just move their residence, the costs of moving—including renting a moving truck, finding and renting a new home, and perhaps missing work—would far outweigh the money from a state EITC. Finally, of Kentucky's six bordering states, three already have EITCs (IL, IN and VA), so their residents would not even have a theoretical incentive to move to KY.

[1] http://www.cbpp.org/cms/index.cfm?fa=view&id=3556

NORTH AMERICAN STAINLESS

Address: 6870 Highway 42 East
Ghent, KY 41045

Telephone: (502) 347-6000

October 31, 2012

via UPS Overnight

Mr. John A. Williams
c/o Ms. Shannon L. Tivitt, Chief of Staff
Office of Lieutenant Governor Jerry E. Abramson
The State Capitol, Room 142
700 Capitol Avenue
Frankfort, KY 40601

Dear Mr. Williams:

Since we are unaware of the procedure for providing information to you, I am taking the liberty of sending the information in care of Ms. Tivitt.

As you may recall, on July 24, 2012, Pat Graf, Tax Manager of our company, testified before the Commission, emphasizing the importance of single factor apportionment. Carol Shelton, General Account Manager of our company, attended the October 23 meeting and advised that you discussed single factor apportionment. Therefore, in the hopes that it may be of interest, I am enclosing a March 2010 "white paper" prepared by KPMG concerning the importance of single factor apportionment to economic development and job creation/preservation. The white paper was prepared at the request of the Kentucky Single Sales Factor Coalition which was formed in 2009. The members were companies with business activities in multiple states, which had seen their tax responsibility increase in Kentucky as other states promote in-state investment through changes to the apportionment formula to provide their businesses with a "home state" advantage. The members were: Amazon, Beam Global Spirits & Wine, Inc., Brown-Forman Corporation, E.ON U.S. LLC, Kindred Healthcare, Inc., Lexmark, Marathon Oil Company/Marathon Petroleum Company LLC, NewPage Corporation, North American Stainless, Papa John's, Rescare, Tempur-Pedic International Inc., Texas Roadhouse, Toyota, United Parcel Service, Inc., and Yum Brands, Inc.

We hope the white paper will be of interest and thank you and all the Commissioners for your time and effort on behalf of all Kentuckians.

Sincerely,

Mary Jean Riley

Mary Jean Riley
Vice President, Finance and Administration,
Treasurer

EXCERPTS FROM KPMG – THE IMPACT OF SINGLE SALES FACTOR APPORTIONMENT ON ECONOMIC DEVELOPMENT, MARCH 2010

"KPMG LLP's Global Location and Expansion Services Group (GLES) is a global practice providing economic development solutions including: Site Selection/Location Analysis; Business Incentive Analysis and Negotiation; Economic Development Consulting."

"Effective in tax year 2011, 23 states will either require use of the single sales factor as their apportionment formula (or be in the process of phasing it in) or will allow certain industry groups to use a single sales factor on an optional basis."

"The single sales factor apportionment formula is considered to be a primary tool for promoting investment in a state."

"Some businesses performing a site selection will not even consider locations that do not offer a competitive corporate income tax environment."

"A single sales factor apportionment formula can be viewed as an efficient tax incentive. . . . An example of the difference in tax incentives offered by a single sales factor state versus a double weighted sales factor state is Kentucky's offer of $30 million in tax incentives compared to the $18.5 million offered by Indiana for the Medco Health Solutions Inc. project. Despite a more lucrative incentive offer from Kentucky, the company chose to locate its new $150 million, 1,300 job automated pharmacy operation project in Indiana."

"KPMG is currently involved with an ongoing site selection project for a corporate headquarters and manufacturing facility. Kentucky and Pennsylvania are two of the finalist states the business is considering for the project. Pennsylvania currently uses a 90 percent sales factor apportionment formula while Kentucky uses a 50 percent sales factor. The difference in apportionment formulas could result in a competitive edge for Pennsylvania if other criteria are equal."

"As businesses seek tax savings to remain competitive in the face of economic uncertainty, the lack of a single sales factor may be viewed as a negative for Kentucky."

"Although some states are facing budgetary crises that have negatively affected incentive programs, other states are making positive changes to tax structures and incentive programs as part of their continued development strategy."

KPMG

The Impact of Single Sales Factor Apportionment on Economic Development

MARCH 2010

Tax

AUDIT ▪ TAX ▪ ADVISORY

I. EXECUTIVE SUMMARY

The trend in state taxation to utilize an apportionment formula that increases the weight of the sales factor has accelerated in recent years. In fact, only a distinct minority of states still require all corporations doing business in their state to use an equally weighted three factor apportionment formula. More importantly, a large number of states have migrated to the use of an apportionment formula based solely on sales, the single sales factor formula. A principal rationale for single sales factor apportionment is that the formula enhances a state's economic development posture by ensuring that increased investment and job creation in the state do not, in and of themselves, increase a firm's relative tax burden.

In our experience as a global practice providing economic development site selection/location analysis and business incentive analysis and negotiation services, a state's tax structure can significantly increase or decrease a state's competitive edge in a corporation's location decision. A single sales factor apportionment formula is often viewed as an important part of a development-friendly state tax structure. While tax incentives can be an important economic development tool, a single sales factor apportionment formula can be considered a more efficient approach to providing an investment incentive. The incremental value a company may receive through tax incentives for investing in a state that does not allow a single sales factor will erode as the property and payroll factors increase.

Kentucky's current corporate income tax structure includes a double-weighted sales factor apportionment formula. Under the current formula, as payroll and property within the Commonwealth's borders increase, a corporation's effective state tax rate also increases (other things remaining equal,) which can be seen as penalizing the corporation for bringing jobs and investment to Commonwealth. When a corporation creates jobs and investment in a state that allows a single sales factor formula, the corporation's income tax liability will not change based solely on the increased physical presence in the state.

Costs including location costs, start-up costs, and operating cost, are the primary consideration in most location decisions, especially in today's economy. The cost savings many corporations enjoy by locating in a single sales factor states are significant and recurring. In fact, based on our site selection experience, if corporate income tax is one of the most important criteria for a manufacturer or headquarters location, Kentucky will likely not be included on the initial list of states under consideration. By allowing corporations to use a single sales factor apportionment formula, Kentucky could be seen as a more attractive option for large corporations making significant capital investments and creating new jobs.

A majority of income tax states authorize single sales factor for some or all industries. As more states move to a single sales factor apportionment formula, Kentucky will likely face increased competition as a location by businesses interested in operating cost savings. Changes to the Kentucky tax structure can improve the relative attractiveness of the Commonwealth as a location for business investment and job creation.

II. OVERVIEW

To pass Constitutional scrutiny, a state tax levied against an entity operating in interstate commerce must, among other things, be fairly apportioned so as to reflect the level of activity in the state and avoid the risk of multiple taxation.[1] For corporation income tax purposes, states commonly meet this requirement by apportioning or dividing the income of an enterprise doing business in multiple states by use of a formula that generally reflects the relative proportion of the property, payroll and sales in the taxing state compared to the property, payroll and sales of the enterprise in all states – commonly called the "three factor formula." States traditionally assigned each of the three factors an "equal weight," meaning that each of the individual ratios of property, payroll and sales in the state to property, payroll and sales in all states would be computed, added together and divided by three to determine the proportion of the enterprise income to be apportioned to the state for income tax purposes.

Over the past two decades, states have shifted substantially to apportionment formulas that increase the weight of the sales factor. In fact, only a distinct minority of states currently use the traditional equally weighted three factor formula, and a number of states have adopted an apportionment formula based solely on sales – the single sales factor formula. One of the principal rationales for increasing the sales factor weighting and for adopting a single sales factor approach is to promote economic development. The single sales factor apportionment formula eliminates the property and payroll factors in determining the amount of income apportioned to a state, thus ensuring that increased capital investment and job creation in the state will not, in and of themselves, increase the relative corporate tax liability in the state.

This report examines the impact of a single sales factor apportionment formula in business location and expansion decisions. Specifically, a single sales factor formula may make a state more competitive by negating the impact of any increased investment in property and people on a corporation's income burden.[2]

III. ABOUT US

KPMG LLP's Global Location and Expansion Services Group (GLES) is a global practice providing economic development solutions including:

- Site Selection/Location Analysis
- Business Incentive Analysis and Negotiation
- Economic Development Consulting

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[1] *Complete Auto Transit, Inc. v Brady* 430 U.S. 274 (1977)

[2] While they are not reviewed here, a variety of academic studies have found that increased weighting of the sales factor is a significant factor in explaining differences in investment and job creation across states. See, for example, Goolsbee, Austan, and Edward L. Maydew. "The Economic Impact of Single Factor Sales Apportionment for the State of New York." New York, NY: The Public Policy Institute of New York State, Inc., November, 2000b; Edmiston, Kelly D., and F. Javier Arze. "Economic Effects of Apportionment Formula Changes: Results From a Panel of Corporate Income Tax Returns." Federal Reserve Bank of Kansas City. Mimeo, 2004; and Edmiston, Kelly D. "Strategic Apportionment of the State Corporate Income Tax: An Applied General Equilibrium Analysis." *National Tax Journal* 55, no.2 (June 2002): 239-62

Nationally, GLES is a network of over 50 economic development professionals, consisting of tax accountants, real estate consultants, property consultants, industry consultants, attorneys, economists and valuation specialists. KPMG's GLES practice brings extensive knowledge and experience with economic development at the state, regional and local levels. Many of our GLES professionals have held key state-level positions and have had a part in establishing many of the current state and local economic development policies in place today. In fact, most of our GLES professionals have previous experience working for a state, regional, or local economic development agency.

IV. STATE APPORTIONMENT FORMULA TRENDS

States determine which factors and the weighting of the factors they use to determine the proportion of a company's income to be apportioned to the state for income tax purposes. To encourage a uniform approach to the taxation of multistate businesses, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. UDITPA contained an equally weighted three factor formula for apportionment purposes, and over the next 20 years, nearly every state with a corporate income tax adopted the equally weighted three factor formula. Currently, fewer than 10 states still require all corporations doing business in their state to use an equally weighted three factor apportionment formula [see Chart 1].

In 1978, the U.S. Supreme Court ruling in *Moorman Manufacturing Co. v. Bair*[3], clarified that states are not constitutionally required to tax corporations on the three factor formula and upheld Iowa's use of a single sales factor to apportion the income of a multistate business. Since that time, there has been a steady movement of states away from the equally weighted formula to one that increases the relative weighting of the sales factor. Over the last 15 years or so, the increased weighting of the sales factor has been driven primarily by a desire on the part of the states to improve their relative competitive position for attracting business locations, capital investment and job creation activities. As company locations and capital became more mobile and interstate competition for expansion projects intensified, states increasingly began to see the income tax apportionment formula as a way to differentiate themselves from other states and to gain a comparative advantage *vis a vis* other states.

V. CURRENT STATE APPORTIONMENT FORMULAS

Effective in tax year 2011, 23 states will either require use of the single sales factor as their apportionment formula (or be in the process of phasing it in) or will allow certain industry groups to use a single sales factor on an optional basis.[4] Arizona, California, New York, and Virginia are among the most recent states to enact provisions to allow a single sales factor. By contrast, only 10 states use an equally weighted three factor formula, and three of these allow an alternative that places greater weight on the sales factor in certain instances. Chart 1 provides a summary of the state corporate income tax apportionment weightings by formula.

Several of Kentucky's neighboring states already allow the use of a single sales factor apportionment or are in the process of phasing it in, including Indiana, Illinois, Michigan, Missouri, Ohio and Virginia.

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[3] *Moorman Manufacturing Co. v. Bair* 437 U.S. 267 (1978)

[4] In addition, Pennsylvania uses a 90 percent sales factor and South Carolina provides taxpayers with 80 percent of the benefit of single sales factor.

Chart 1: State Apportionment Formulas by Category[5]

Three-factor Equally Weighted Formula	Double-Weighted Sales/Enhanced Sales Formula	Single Sales (or Phase-in) Formula[6]	Single Sales Factor Allowed for Some Industries
Alabama	Arkansas	Arizona	Connecticut
Alaska	Florida	California	Louisiana
Delaware	Idaho	Colorado	Massachusetts
District of Columbia	Kentucky	Georgia	North Carolina (1)
Hawaii	Maryland	Illinois	Virginia
Kansas (1)	New Hampshire	Indiana	
Montana	New Jersey	Iowa	
North Dakota	New Mexico	Maine	
Oklahoma (2)	Tennessee	Michigan	
Rhode Island (2)	Utah	Minnesota	
	Vermont	Mississippi	
	West Virginia	Missouri	
		Nebraska	
		New York	
		Ohio	
		Oregon	
		Pennsylvania (3)	
		South Carolina (4)	
		Texas	
		Wisconsin	

(1) Election to use single sales factor is available to certain corporations
(2) Alternative formula with enhanced sales factor available for qualifying corporations
(3) Pennsylvania places a 90 percent weight on the sales factor.
(4) Taxpayer is allowed 80 percent of difference between double-weighted sales and single sales factor.

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[5] *KPMG compilation based on various sources, including 2010 Thomson Reuters/RIA, Federation of Tax Administrators, and Multistate Corporate Income Tax Guide by JC Healy and MS Shadewald, 2009*
[6] *The Washington B&O tax has an economic effect similar to the Ohio gross receipts tax with a single sales factor.*

VI. IMPACT ON ATTRACTING AND RETAINING BUSINESSES

The single sales factor apportionment formula is considered to be a primary tool for promoting investment in a state. States with a low statutory tax rate coupled with single-sales factor apportionment formula tend to have the more competitive tax environments. States that use a three factor formula may be viewed as being at a distinct disadvantage for competitive investment decisions in property and payroll intensive business operations because the effect of the three-factor formula is to increase the effective tax rate for a company that is investing in new property and creating jobs.[7]

Location decisions are generally driven by a combination of criteria such as labor costs, labor availability, labor quality, infrastructure, regulatory environment, energy costs as well as state and local tax implications. Of these criteria, recurring operating cost factors such as labor costs and state and local taxes are primary considerations in assessing the attractiveness of a state's business environment. Labor costs are usually similar for locations within the same geographic region and size; therefore, state and local taxes can become a key consideration.

The following charts illustrate the impact of a double-weighted sales factor versus a single sales factor apportionment formula on state corporate income tax liability for a business expansion project and a new business attraction project.

Chart 2: Business Retention Project: Impact of Apportionment Formula

ABC Mfg. Corporation Investment Analysis
Expansion Project
Impact on state corporate income tax when subject to Single Sales Factor v. Double-Weighted Sales Apportionment Formula

Baseline Income and Apportionment Information

		Kentucky		Everywhere
Property	$	200,000,000	$	500,000,000
Payroll	$	50,000,000	$	125,000,000
Sales	$	10,000,000	$	200,000,000
Net Income	$	80,000,000		
Statutory Tax Rate		6%		

Base Effective Tax Rates & Annual Taxes Due

		Double-Weighted Sales		Single Sales Factor
Effective Tax Rate		1.35%		0.30%
Tax Liability	$	1,080,000	$	240,000

Income and Apportionment information after new investment of $100 million in property adding $20 million payroll

		Kentucky		Everywhere
Property	$	300,000,000	$	600,000,000
Payroll	$	70,000,000	$	145,000,000
Sales	$	10,000,000	$	200,000,000

Effective Tax Rates & Annual Taxes Due After Investment

		Double-Weighted Sales		Single Sales Factor
Effective Tax Rate		1.62%		0.30%
Tax Liability	$	1,299,310	$	240,000

Annual Incentive to Invest New Payroll and Property In SSF State	$	**219,310**

[7] It is this rationale that caused a Transition Task Force for Gov. Christie to recommend adoption of single sales factor in New Jersey, citing the current three factor formula as an "investment and employment tax." See *Report of the Transition Team, Subcommittee on Economic Development and Job Growth, Governor Christie,* January 14, 2010, p. 3.

As shown in Chart 2, the hypothetical operating cost differential between a double weighted sales factor state such as Kentucky and a single sales factor state is an additional $219,310 annually. The operating cost differential equals the difference in the hypothetical tax liability in the double-weighted sales state prior to the addition of new payroll and property to the state and the tax liability in the double-weighted sales state following the hypothetical expansion project. The increase in tax in this hypothetical example, thus potentially acts as a disincentive to in-state investment and job creation. Accordingly, the increase in tax related to the expansion might be viewed as the annual disadvantage the Commonwealth faces in seeking investment from this hypothetical firm. This scenario is common among businesses that have operations in multiple states. When a corporation is looking to expand, it will perform a cost comparison analysis between the states in which it has existing operations to determine where the expansion should be located. In this situation, Kentucky would fare less favorably than similar states that utilize a single sales factor apportionment formula such as Indiana.

Chart 3: Business Attraction Project: Impact of Apportionment Formula

ABC Mfg. Corporation Investment Analysis
Attraction Project
Impact on state corporate income tax when subject to Single Sales Factor v. Double-Weighted Sales Apportionment Formula

Baseline Income and Apportionment Information

	Kentucky	Everywhere
Property	$ -	$ 500,000,000
Payroll	$ -	$ 125,000,000
Sales	$ 10,000,000	$ 200,000,000
Net Income	$ 80,000,000	
Statutory Tax Rate	6%	

Base Effective Tax Rates & Annual Taxes Due

	Double-Weighted Sales	Single Sales Factor
Effective Tax Rate	0.15%	0.30%
Tax Liability	$ 120,000	$ 240,000

Income and Apportionment information after new investment of $100 million in property adding $20 million payroll

	Kentucky	Everywhere
Property	$ 100,000,000	$ 600,000,000
Payroll	$ 20,000,000	$ 145,000,000
Sales	$ 10,000,000	$ 200,000,000

Effective Tax Rates & Annual Taxes Due After Investment

	Double-Weighted Sales	Single Sales Factor
Effective Tax Rate	0.61%	0.30%
Tax Liability	$ 485,517	$ 240,000

Annual Incentive to Invest New Payroll and Property in SSF State **$ 365,517**

The new business attraction scenario presented in Chart 3 shows the increase in hypothetical corporate income tax liability related to an investment in property and payroll by a company that currently has no physical presence in Kentucky. In this hypothetical, the operating cost differential between a double weighted sales factor state such as Kentucky and a single sales factor state is an additional $365,517 annually. The new business attraction case becomes even more concerning when considering the most competitive "mega projects." For projects proposing the creation of thousands of high paying jobs and hundreds of millions in new investment the annual cost disparity between single sales factor states and Kentucky would be even more pronounced.

A single sales factor apportionment formula can be viewed as an efficient tax incentive. States sometimes try to compensate for lack of a single sales factor apportionment formula by offering tax incentives to mitigate the gap in corporate income tax liability. These tax incentive programs can be administratively burdensome to the corporation as well as the state government. Further, tax incentive programs normally offer a smaller benefit when compared to single sales factor apportionment due to statutory and budgetary limitations.

An example of the difference in tax incentives offered by a single sales factor state versus a double weighted sales factor state is Kentucky's offer of $30 million in tax incentives compared to the $18.5 million offered by Indiana for the Medco Health Solutions Inc. project. Despite a more lucrative incentive offer from Kentucky, the company chose to locate its new $150 million, 1,300 job automated pharmacy operation project in Indiana. Over time an increase in the property and payroll factors resulting from a project will likely erode the incremental value a company receives from tax incentives.

As the Medco Health Solutions Inc. project demonstrates, the finalist stage of site selection projects involves a level of subjectivity from the business in its decision. KPMG is currently involved with an ongoing site selection project for a corporate headquarters and manufacturing facility. Kentucky and Pennsylvania are two of the finalist states the business is considering for the project. Pennsylvania currently uses a 90 percent sales factor apportionment formula while Kentucky uses a 50 percent sales factor. The difference in apportionment formulas could result in a competitive edge for Pennsylvania if other criteria are equal.

Some businesses performing a site selection will not even consider locations that do not offer a competitive corporate income tax environment. Based on our site selection experience, if corporate income tax is one of the most important criteria for a manufacturer or headquarters location, Kentucky will likely not be included on the initial list of states under consideration.

In performing a site selection a variety of deciding factors with varying degrees of importance are considered. Cost, however, is always extremely important to any company performing location analysis. In fact, cost savings have never been more important to businesses than in the current economic climate. A 2009 survey of corporate executives on site selection matters conducted by *Area Development* found that 7 of the top 10 site selection factors are cost driven, and 87% of the respondents indicated that the corporate tax rate is the fifth most important factor in the location analysis process.[8]

State and local incentives ranked eighth in importance in the 2009 survey. A majority of respondents indicated that tax incentives were the most important type of incentive when making a location decision[9]. This is an important point to highlight because in a time of economic downtown, companies ordinarily place a high importance on financial incentives such as grants, bonds and loans. However, the respondents to the study ranked tax incentives to have a higher relative importance than financial incentives when making location decisions. This demonstrates the importance that corporations place on tax considerations. As businesses seek tax savings to remain competitive in the face of economic uncertainty, the lack of a single sales factor may be viewed as a negative for Kentucky.

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[8] Gambale, Geraldine. "The 24th Annual Corporate Survey & 6th Annual Consultants Survey." *Area Development Site and Facility Planning* January 2009/July 2010: 23-69. Print.
[9] *Id.*

Overall costs including location costs, start-up costs, and operations costs are the primary consideration in location decisions in today's market. Corporations seek locations with comparatively low and stable cost profiles. Single sales factor apportionment is a contributing factoring in the state tax impact on recurring operating costs. Although some states are facing budgetary crises that have negatively affected incentive programs, other states are making positive changes to tax structures and incentive programs as part of their continued development strategy.

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November 14, 2012

The Honorable Jerry Abramson
Lt. Governor
Commonwealth of Kentucky
700 Capitol Avenue, Suite 142
Frankfort, Kentucky 40601

RE: Blue Ribbon Commission on Tax Reform - Retiree Tax Burdens

Dear Governor Abramson:

On behalf of our 460,000 Kentucky AARP members and the hundreds of thousands Kentuckians approaching retirement age, AARP Kentucky writes to express our alarm and concern regarding changes in the state tax code that would increase tax burdens of retirees. We urge the Commission to exercise caution as it considers proposals to reduce the amount of retirement income exempt from taxation and increasing taxes on Social Security benefits.

Social Security is the principal source of income for nearly two-thirds of older American households receiving benefits, and roughly one third of those households depend on Social Security for nearly all of their income. Half of those 65 and older have annual incomes below $18,500, and many older Americans have recently endured significant losses in retirement savings and home values. Today, every dollar of the average Social Security retirement benefit in Kentucky of $13,759 is absolutely critical to the typical beneficiary.

In prior testimony before the Commission, AARP Kentucky recommended seeking a fair and balanced approach to improving the state's tax code. AARP again urges the Commission to consider the significant savings available for taxpayers today by increasing in-home aging services and decreasing the Medicaid program's reliance on less cost effective nursing home care.

Too many Kentucky retirees today live in or near the poverty line and struggle to make ends meet. With 13 percent of Kentucky's seniors living in poverty today, asking those on fixed incomes to bear more tax burden to balance or enhance the state budget is not a long-term solution.

Thank you for your consideration and we appreciate the challenge before the Commission to find solutions that best serve all Kentuckians fairly today and for future generations.

Sincerely,

James T. Kimbrough
State President

Ron Bridges
State Director

CC: The Honorable Steve Beshear, Governor
Blue Ribbon Commission on Tax Reform Members

Steven L. Beshear
Governor

OFFICE OF THE GOVERNOR
KENTUCKY OFFICE OF HOMELAND SECURITY
Office of the 911 Coordinator/
CMRS Board

Joe Barrows
Executive Director

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TO: Governor's Blue Ribbon Commission on Tax Reform
FROM: Joe Barrows, State 911 Coordinator
REGARDING: Funding of 911 Services in Kentucky, Tax Policy Issues
DATE: September 26th, 2012
ATTACHED: Article, KACO's "COUNTY LINE" Magazine, "HELP 9-1-1"

INTRODUCTION: Virtually everyone knows that when faced with an emergency you call 911 for help. Very few know anything about the technology, infrastructure, process, organization, personnel and other costs associated with providing 911 services or the revenue sources that pay for the service.

One reason for this circumstance is that there is not one entity "in charge" of 911 in the state; or a single governance and organizational model –governance, organization and funding are split between the State (CMRS Board, State Police) and city and county local government operating with a multitude of inter-local agreements, MOUs, PSAP certification, etc.

And, more to the point for the Commission, few would know whether there are issues of fairness, competitiveness, simplicity and compliance, elasticity and adequacy associated with those revenue sources that are directly related to 911 service.

Currently there are three main sources of funds that pay for 911 services in the State; A) Local 911 Fee on landline phones, B) State 911 Surcharge on cell phones and C) Local 'General Funds" budgeted by City and County governments for 911. Let's examine each in light of the Commission's charge.

BACKGROUND: Pre 1998, 911 was a local government service established by ordinance; paid entirely by local government through locally enacted landline fees and augmented with local general funds.

In 1998 the CMRS Board was created by act of the General Assembly in response to a national order from the FCC directing states and providers of cell phone service to make 911 calls from cell phones "work" (KRS 65.7621 et seq).

A surcharge of 70¢ per month per active cell phone (CMRS connection) was established to provide the resources to pay for the initiative –generally the fee is collected by the service provider from the

subscriber on the monthly bill for services (contract plan or postpaid model). The service provider remits the amount collected each month directly to the CMRS Board.

Funds collected are distributed by statutory formula. The largest share is sent directly back to local "certified" PSAPs to pay for specified, permissible 911 costs that cover day to day operations. A portion of CMRS funds are also paid to companies to allow 'cost recovery' for expenditures they make for improving wireless 911 service.

Currently, providers of all sizes remit to the Board. Annual collections total around $24.5 million. About 10 major companies (and their subsidiaries) account for 98% of the amounts remitted.

A second business model for cell phone service exists by which providers sell the minutes through 3rd party retailers via "phone cards" that are activated by the provider (prepaid model). Collection of the 911 fee from providers on their prepaid cell phone connections has been a contentious issue nationally.

When originally enacted, the CMRS service charge was assessed on every "CMRS connection" (cell phone) in the state without any differentiation based on the business model used by the provider of cell phone service.

Providers of "prepaid" services in the 2003-2005 time frame unilaterally decided that the law didn't apply to their business model (sale of minutes by phone card thru retail establishments rather than contracts with the provider) and stopped remitting the fee to the CMRS Board.[1]

Amendments to the statute enacted in 2006 explicitly mention "prepaid" providers and direct them how to calculate the CMRS surcharge for "prepaid" cell phones. [KRS 65.7635(1)]

The amendment makes it clear that prepaid providers were covered by the law and was intended to give them options on how to determine their remittance obligation. The amendment created a distinction in how 911 fees were assessed as between "prepaid" and "postpaid" cell phones. The amendment was **not intended** to create a different level of support between prepaid and postpaid phones. However that is what happened. The statutory calculation results in "prepaid" phones generating on average about 40¢ per month in 911 revenue compared to the 70¢ per month paid by postpaid phones.

This was an unintended consequence of the 2006 amendments. There is no distinction between prepaid and postpaid phones in terms of use, technology or impact on the 911 system and so no justification for the disparity in level of support between them.

This disparity results in a 'loss' to the CMRS fund of an estimated $3.5 million annually—some $18 million since the amendment was adopted. Seventy percent (70%) of this money goes directly back to local governments to pay for the day to day costs to provide 911 service—at a time when local 911 revenues from landline phones are shrinking and local general fund budgets are stretched.

TAX (FEE) AND FUNDING ISSUES:
1) Is the cell phone component (providers and users) of the communication industry paying its share of the cost to provide 911 service compared to local governments and landline users?
Consider these factors:

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[1] The CMRS Board sued two providers for "unremitted fees" and has trial court judgments totaling $6 million in unremitted fees and attorney fees which are currently on appeal.

-Of the three primary sources of funds paying for 911 services, the portion coming from "wireless" 911 fees pays the least –estimated in the 15-20% range on annual collection of $24 million –compared to landline fees generating $30-35 million statewide and local general fund subsidies at $50 plus million.

-The 70¢ fee on cell phones is lower than all but 5 local county landline fees which average $1.50-$2.00 per month, sixteen are over $3.00 per month.

-In 2001, there were 2.4 million wireline connections in Kentucky and 1.6 million cell phones. Today there are 3.6 million cell phone subscribers in Kentucky compared to 1.6 million wireline connections (landline phones, cable VoIP).

-Local governments have experienced a corresponding decrease in revenues from local 911 landline fees.

-Seventy percent (70%) of 911 calls now originate from cell phones.

-The 70¢ fee on cell phones has never been raised.

-The disparity between prepaid and postpaid level of support was not known until recently.

2) Why is there a disparity between 'prepaid' phones and 'postpaid' phones? Should there be a disparity?

'Postpaid' cell phones are assessed a 70¢ fee per month based on their "active" existence. Since 2006, 'prepaid' cell phones are assessed based on statutory formula (KRS 65.7635(1)) to wit: a company's total earned prepaid wireless revenues divided by 50 and multiplied by 70¢ equals the 911 surcharge remittance due. This formula was 'faulty' from the beginning and has the unintended consequence of having prepaid phones generate on average only about 40¢ per month of revenue. Since there is no distinction between 'prepaid' and 'postpaid' phone in terms of their technology or impact on the system, is there any justification for assessing the 911 fee differently based on how minutes are paid for –or permitting different levels of support? The CMRS Board believes all cell phones should support the system the same.

3) Does the current funding system provide adequate resources for 911 services?

The current analog delivery system is old technology that needs upgrading. Next Generation 911, soon to be 'ordered' by the FCC, will be digital and delivered by "IP networks." These demands present a statewide looming crises in 911 funding when you consider that the fee based funding is shrinking or stagnant. Landline phones are disappearing and so the local funding base is shrinking. Collection of CMRS (cell phone) revenues have been level for three fiscal years indicating a saturated market. Users of 'postpaid' phones have been migrating to 'prepaid' phones (now 20% of the market) which pay less to support the system.

The 70¢ fee has never been raised. An increase to $1.50 (about the average landline fee) would generate $37 million new dollars –enough to migrate to Next Generation 911 capacity in a relatively short period of time.

4) Do local governments have options to increase revenue for 911 services?

Given that local governments already pay the largest share of the cost to provide 911 services from their general funds, and given that their resources and budgets are stretched, it is hard to argue that it's their responsibility to address the adequacy issue. Nevertheless, short term help may be required.

KRS 65.760 provides the authority for local governments to adopt "landline fees" dedicated to 911, but with shrinking landline numbers and landline fees which exceed the cell phone fee, the 'other' options to raise revenue for 911 services that the statute also provides need to be examined and utilized.

5) What is the "Point of Sale" (POS) proposal for collecting 911 fees on "prepaid" services?

In the past few years the wireless industry, including their national association (CTIA) has pushed for another legislative solution to the collection of 911 fees on prepaid phones thru 'model legislation' dubbed the Retail Point of Sale method. The Point of Sale (POS) model has the 911 fee for prepaid being collected by the retailer when the consumer buys the phone card –analogous to the collection (and on top of) the sales tax. The 911 fee could be a 'flat fee' added to the price of the card or a 'percentage' of the sales price of the card –for Kentucky, process wise, it would mean moving from a wholesale collection of 911 fees (for both prepaid and postpaid) where a small number of companies simply write a check monthly to the CMRS Board to a "bifurcated' process –postpaid would remain the same, but for prepaid, thousands of retailers would collect the POS 911 fee, remit to the Revenue Department, which would then transfer collections to the CMRS fund.

Under POS, the 911 fee on cell phones is 'assessed' two different ways. For postpaid phone service the fee is 70¢ per device per month based on its "active existence." For prepaid, the fee collected becomes a function of the number of cards (minutes) purchased by the subscribers.

There is no reason to differentiate between cell phones loaded with prepaid minutes versus those with postpaid minutes in the imposition of and level of a 911 surcharge. The devices are the same, they function the same and impact the system the same.

In theory the Board should not care how the CMRS fee is collected so long as it collected on every cell phone and every cell phone pays the same level of support. However, it is the contention of the State 911 Coordinator that POS legislation, as proposed, attempts to lock in and continue the disparity between prepaid and postpaid. (POS bills introduced in recent sessions use 1.4% of the sale price of the 'card' as the 911 surcharge.)

This "shortchanging of 911" has occurred in the two dozen states that have recently adopted POS, regardless of whether they used a flat fee or percentage of sales price for the POS 911 fee.

Little effort has been made by policy makers to determine what the flat fee or percentage would have to be so that revenues from prepaid under POS would equate to the amount of revenue generated if each prepaid phone paid 70¢ per month.

Due to shrinking resources to pay for 911 services, removing the disparity between prepaid and postpaid should be a high priority for the administration. There are (at least) three ways that it could be accomplished:

A) Repeal the 2006 amendments and return to the 'original' 911 collection method –each device pays 70¢ per month. Courts have ruled that the original statute applied to all CMRS connections (prepaid and postpaid) validating a simple wholesale collection process where providers simply multiply their subscriber count by 70¢ and send the remittance to the Board.

B) Amend the existing statue to have the revenue formula (Option B) generate the 'equivalent' revenue.
C) Adopt another method to calculate the 911 fee for prepaid (like POS) provided it generates equivalent revenue.

There are pros and cons to each option –both B and C require analysis of data and 'computations' heretofore not done in other states due to lack of basic data to make such 'equivalency determinations.

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September 7, 2012

Thomas C. Nugent
President, Nugent Sand Company
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Louisville, KY 40206-6072

Re: Proposal to Amend KRS Chapter 143A

Dear Tom:

You have asked us to review a proposed amendment to KRS Chapter 143A contained in section 12 of 12 RS HB 499/SDS1. In general, the proposed amendment would modify the definition of "processing" set forth at KRS 143A.010(6) to make taxable in Kentucky the mere act of loading or unloading in Kentucky limestone that has not been severed, cleaned, broken, crushed, dried, sized or otherwise treated in Kentucky.

The singling out of limestone in this manner appears arbitrary and capricious. As a consequence, the proposal raises serious questions under the United States Constitution.

As a rule, the legislature has considerable latitude to create reasonable classifications for tax purposes, so long as the classifications serve legitimate interests. We can think of no legitimate interest that will be served by discriminating against limestone in this manner. The mere act of loading or unloading limestone adds nothing to its value. Moreover, imposing a tax where the taxpayer's only act in Kentucky consists of loading or unloading limestone that has neither been severed nor treated in Kentucky is contrary to the fundamental purpose of Kentucky's mineral severance tax. Under the circumstances, it can fairly be said that the proposed amendment appears designed solely to impose a confiscatory measure on persons who sell non-Kentucky limestone to customers in Kentucky in competition with Kentucky limestone producers.

We note that, under the coal severance tax provisions of KRS Chapter 143, the term "processing," as defined by KRS 143.010(8), does not include the act of loading or unloading coal that has not been severed, cleaned,

WYATT, TARRANT & COMBS, LLP

broken, sized or otherwise treated in Kentucky. We can think of no legitimate interest that is served by treating limestone differently than coal for these purposes.

Based on the foregoing, we believe the proposed amendment, if challenged on constitutional grounds, would not survive.

Sincerely,

Richard Northern
James A. Nitsche

RN/srn

60244008.1

KENTUCKY PUBLIC RETIREES P. O. BOX 4082 FRANKFORT, KENTUCKY 40604

www.kentuckypublicretirees.org

September 26, 2012

The Honorable Jerry E. Abramson
Lieutenant Governor
Chairman of the Blue Ribbon
Commission on Tax Reform
700 Capitol Avenue, Suite 142
Frankfort, Kentucky 40601

Dear Mr. Abramson:

On behalf of Kentucky Public Retirees, Incorporated, I am transmitting the Resolution which was adopted at our last quarterly board meeting held on September 20, 2012. Kentucky Public Retirees is a non-profit association of retirees and retirement-eligible employees of state, local, and state police governments.

We certainly hope that you will give this resolution every consideration when determining tax structure changes in the system.

Sincerely,

Paul R Guffey

Paul R. Guffey
KPR State President

Attachment - Resolution

RESOLUTION

Kentucky Public Retirees, Inc. (KPR), a non-profit association of retirees and retirement-eligible employees of the state, local, and state police governments, at its Board Meeting in Frankfort, Kentucky, on the 20th day of September, 2012, did adopt the following Resolution, by unanimous decision.

Whereas, KPR was formed to protect the retirement benefits of retirees and current employees; and

Whereas, KPR is dedicated to ensuring the general welfare of retirees and current employees;

Resolved, That KPR go on record as opposing any change to the Kentucky Revised Statutes which would disallow the existing exemption of retiree benefits from state income taxes.

Paul R Guffey

Paul R. Guffey, President
Kentucky Public Retirees, Inc.

KENTUCKIANS FOR THE COMMONWEALTH
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Action for Justice

STATEMENT TO THE BLUE RIBBON COMMISSION ON TAX REFORM

On behalf of Kentuckians For The Commonwealth, a citizens' organization of 6400 members across the state working together for a better Kentucky, thank you for your service on the Blue Ribbon Commission commission. Your work represents the best opportunity Kentucky has had in more than a decade to address one of our most pressing needs--one that KFTC has worked on for about a dozen years: adopting tax reform that improves the quality of life by raising revenue fairly.

KFTC stands with the teachers, workers, people of faith communities, health advocates, parents, and other everyday Kentuckians who are urging for adequate funding for some of the most important functions of our state government. KFTC and allies are also encouraged that Governor Beshear identified fairness as one of the goals for the commission's work. To that end, we urge your use of an important tool—a distributional analysis—as you develop your recommendations.

The attached graph is from the Institute of Taxation and Economic Policy (ITEP), a nonprofit, nonpartisan research organization based in Washington, D.C. that focuses on federal and state tax policy. The graph shows the distributional analysis of Kentucky's state and local taxes--how Kentucky's state and local taxes impact taxpayers across income levels. (You might recognize it; an earlier version was included in your "boot camp" presentation.) Put another way, the graph shows the percentage of people's income that goes to state and local taxes.

This graph is an important tool as part of a shared concern for fairness. It answers whether any proposed change improves the regressive character of the current system, or makes it worse. That's why KFTC urges a distributional analysis (which can also performed by the Legislative Resource Commission) for any proposed tax changes coming from the Blue Ribbon Commission. Further, we propose that as part of your recommended reforms, the commission also recommend the continued use of this analysis by our state legislature. Just as the LRC currently performs a fiscal impact of any policy proposal that would impact our state budget, it should also perform a distributional analysis on any proposed tax policy.

Requiring this analysis from a trusted source would establish a clearer frame for good tax policy in Kentucky. It would be a way of agreeing that what happens to ordinary people matters.

Sincerely,

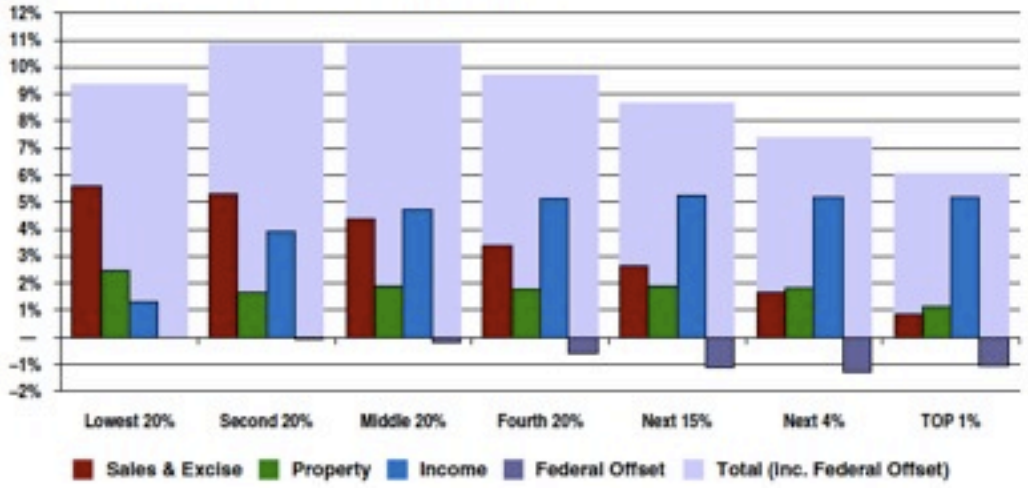
Steve Boyce

Steve Boyce, Chair, Kentuckians For The Commonwealth

Kentucky

State & Local Taxes in 2007

Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20% Next 15%	Top 20% Next 4%	Top 20% TOP 1%
Income Range	Less than $15,000	$15,000 – $29,000	$29,000 – $47,000	$47,000 – $77,000	$77,000 – $140,000	$140,000 – $346,000	$346,000 or more
Average Income in Group	$8,300	$21,700	$36,300	$59,700	$99,100	$203,500	$957,500
Sales & Excise Taxes	**5.6%**	**5.3%**	**4.4%**	**3.4%**	**2.7%**	**1.7%**	**0.9%**
General Sales—Individuals	2.6%	2.7%	2.3%	1.9%	1.5%	1.0%	0.5%
Other Sales & Excise—Ind.	1.3%	1.0%	0.7%	0.5%	0.4%	0.2%	0.1%
Sales & Excise on Business	1.7%	1.7%	1.3%	1.0%	0.8%	0.5%	0.3%
Property Taxes	**2.5%**	**1.7%**	**1.9%**	**1.8%**	**1.9%**	**1.8%**	**1.1%**
Property Taxes on Families	2.4%	1.6%	1.8%	1.7%	1.8%	1.6%	0.6%
Other Property Taxes	0.1%	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%
Income Taxes	**1.3%**	**3.9%**	**4.7%**	**5.1%**	**5.3%**	**5.2%**	**5.2%**
Personal Income Tax	1.3%	3.9%	4.7%	5.1%	5.2%	5.1%	4.8%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%
TOTAL TAXES	**9.4%**	**10.9%**	**11.0%**	**10.3%**	**9.8%**	**8.7%**	**7.1%**
Federal Deduction Offset	–0.0%	–0.1%	–0.2%	–0.6%	–1.1%	–1.3%	–1.1%
TOTAL AFTER OFFSET	**9.4%**	**10.8%**	**10.8%**	**9.7%**	**8.7%**	**7.4%**	**6.1%**

Note: Table shows 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

Who Pays? A Distributional Analysis of the Tax Systems in All 50 States — *Institute on Taxation & Economic Policy – November 2009*

To read the graph:

Income increases from left to right. The first bar represents people in Kentucky's lowest 20% income bracket–people earning less than $15,000. The second bar represents the next 20%. And so on, until the highest 20%, which is broken into the next 15%, then the next 4% and finally to top 1% given the variation in income at that level.

The height of the larger light blue bars represents the portion of their income people pay to Kentucky taxes. The second bar, for example, means that the 20% earning between $15 & $29,000 pay 10.8% of their income to Kentucky taxes. The top 1%--earning at least $346,000, and with an average income of about $950,000--pay on average 6.1% of their income to Kentucky taxes.

The smaller bars represent Kentucky's sales, property, and income taxes. (Note that the sales tax--in red--is especially regressive. The lowest income Kentuckians pay about 5.6% of their income in state sales and excise taxes, while the wealthiest 1% pay only .9% of their income in state sales and excise taxes.)

Supporting Great Communities
and Healthy Landscapes Across Kentucky

Statement on Tax Reform and the Economics of Conservation

The conservation of Kentucky's lands and waters not only helps sustain our wildlife, but contributes billions of dollars to the Kentucky economy in jobs, taxes, tourism and other revenue. Yet often the investment in tax dollars in programs like the Kentucky Heritage Land Conservation Fund, the Purchase of Agricultural Conservation Easement program and the establishment of tax policies, e.g., tax credits for land donations, fail to recognize these are essential investments in the Commonwealth's long-term prosperity.

Conservation Generates Jobs & Strengthens Local Economies

Parks, open space and natural areas provide opportunities for residents and visitors and generate revenue and jobs.

Wildlife Watching

- Contributes $542 million in retail sales and services annually to the Kentucky economy. [1]

Sport Fishing

- Contributes $881 million in retail sales and service to the Kentucky economy.[1]
- Supports 15,000 jobs across Kentucky, yielding $420 million in job income.[1]
- Generates $80 million in state and local tax revenues.[2]

Hunting[3]

- Contributes $439 million in retail sales and services annually to the Kentucky economy.
- Supports 8,400 jobs across Kentucky, yielding $206 million in job income.
- Generates $53 million in state and local tax revenues.

Equine Activities[4]

- Kentucky's vibrant horse industry has a direct economic impact of $2.3 billion annually on the Kentucky economy.
- The equine industry generates $121 million annually in federal, state and local taxes.
- Almost 52,000 direct jobs and 96,000 total jobs are created by the industry.

The lands and waters of Kentucky form the foundation for a strong and vibrant tourism industry in Kentucky. In 2010 Kentucky tourism generated over $11.3 billion in sales, $1.2 billion in state and local taxes and $2.5 billion in wages.[5]

In addition to revenue generated from land conservation, studies of Kentucky counties consistently show that unlike residential land, farmland and open space generate more in public revenues than they receive back in public services such as roads, utilities, police and fire. For example, for every $1 paid in local taxes, working and non-developed land in three Kentucky counties (Campbell, Kenton, and Shelby) required an average of $0.43 in services compared to an average of $1.20 in services for the average urban residential property.[6]

Farmland Preservation Supports Rural Communities

Farmland preservation helps sustain the agriculture industry, secures the food supply, and provides an economic stimulus to rural communities.

- The Kentucky Farmland Protection and Easement Program has purchased easements on 89 farms totaling 21,451 acres.[7]
- Kentucky's farms produced $9.7 billion worth of agricultural products, in 2007, employing 134,000 people.[8]
- The agriculture sector had total direct, indirect, and induced effects on the Kentucky economy of $15.5 billion, in 2007, generating a total of 270,000 jobs.[8]
- Kentucky exported $1.67 billion in food and agricultural products in 2008.[9]
- A total of 147 farmers markets now operating in Kentucky produced $8 million in vendor sales in 2010.[10]
- 'Kentucky Proud', the official farm marketing program of the Kentucky Agriculture Department, generated $200 million in retail sales of Kentucky farm products through member retailers alone in 2010.[10]

Sustainable Forestry Supports the Economy and Environment

Forest land conservation supports the Kentucky economy and environment.

- Kentucky has one of the largest forest products economies in the south, with an estimated $8.7 billion annual impact on the Kentucky economy in 2003.[11]
- Kentucky is the third largest producer of hardwood in the country, generating $6.3 billion in timber shipments in 2004 and employing 22,500 in its wood-processing facilities with an annual payroll value of $788 million.[12]
- Forests protect water quality. The Forest Service estimates that the marginal value of water flowing from national forests, in both offstream and instream uses, is at least $3.7 billion per year.[13]

Conservation Provides Clean Water

Kentucky's forests and open lands play a vital role in the provision of clean drinking water supplies, as well as ensuring that the state's plentiful water bodies continue to attract tourists and their dollars. They reduce the costs of treating wastewater and stormwater, as well as the costs of treating drinking water supplies.

- With more than 1,000 miles of navigable waterways, more than any other state than Alaska, Kentucky's economy benefits from the protection of these vital natural resources.
- Kentucky's Western Lakes & Rivers Region and Southern Lakes & Rivers Region together contributed $630 million to the economy in direct tourist travel expenditures in 2010.[14]
- A study conducted in 2009 by the northern Kentucky Sanitation District No. 1 found that compared to traditional stormwater treatment controls to correct sewer overflows (i.e., pipe replacement and water treatment plants), 'green' controls such as protecting watershed lands provide substantial improvements in water quality relative to their cost.
- Costs of treating drinking water supplies have been found to be directly related to the amount of tree cover in the area, with costs decreasing as tree cover increases. An area with only 10 percent forested land had annual treatment costs of $923,000 compared to $297,000 for an area with 60 percent tree cover. [15]

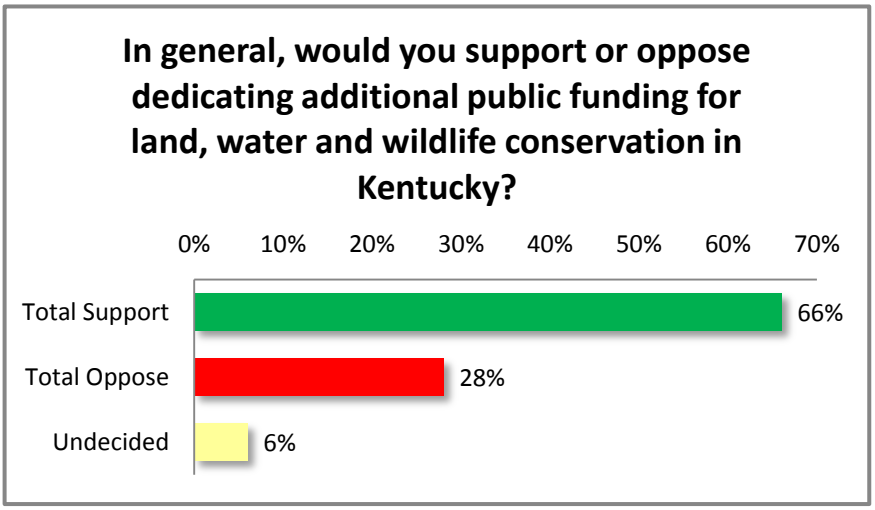
Public Attitudes towards Conservation

Key to understanding and sustaining the links between jobs, the economy and human well-being and the conservation of our lands and waters is to understand the degree to which the people of the Commonwealth are willing to invest public resources to protect and sustain the natural landscapes of Kentucky.

In 2011, the bipartisan research team of Fairbank, Maslin, Maullin, Metz & Associates (Democrat) and Public Opinion Strategies (Republican) conducted a survey of voters in Kentucky to assess their attitudes on a variety of issues related to the conservation of land, water and wildlife in the state.[17] Overall, the survey results show that Kentucky voters enthusiastically support a number of proposals to increase investment in conservation of the state's natural resources. This support remains strong despite voter concerns about the economy and unemployment.

Key findings of the survey include:

- **Two-thirds (66%) of voters support dedicating additional public funding for land, water and wildlife conservation in Kentucky.** When asked directly if they would "support or oppose dedicating additional public funding for land, water and wildlife conservation in Kentucky," two-thirds (66%) of survey respondents indicated they would support such a dedication, including one-quarter (25%) who expressed "strong" support. Only a little more than one-quarter (28%) of respondents expressed opposition, with another six percent undecided.

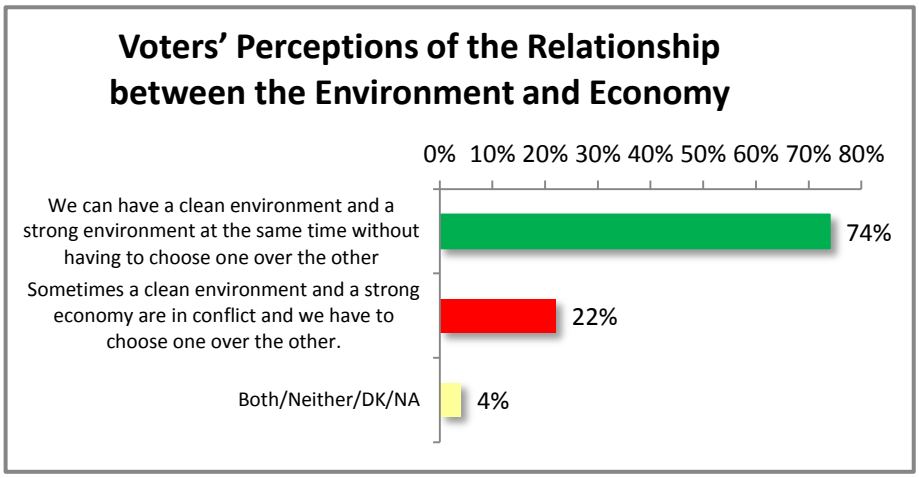


- **Protecting drinking water and flood prevention are top priorities for voters.** Survey respondents were also asked to rate the importance of a variety of specific types of projects that might be carried out if additional funding were available for conservation in Kentucky, indicating whether they found each to be "extremely important," "very important," "somewhat important," or "not important." As shown in Table 2, more than 8 in 10 voters see it as "extremely" or "very" important to protect "sources of drinking water," "water quality in lakes, rivers and streams," and "natural areas along rivers to help prevent flooding." Three-quarters (75%) also place a high priority on "protecting working farmland;" while more than two thirds see it as "extremely" or "very" important to protect "forests," "natural areas," and "fish and wildlife habitat."

Project	Percentage (%)		
	Ext. Import.	Very Import.	Total Ext./Very
Protecting sources of drinking water	45	46	**91**
Protecting water quality in lakes, rivers and streams	41	42	**83**
Protecting natural areas along rivers to help prevent flooding	40	40	**80**
Protecting working farmland	35	40	**75**
Protecting forests	32	37	**69**
Protecting natural areas	31	36	**67**
Protecting fish and wildlife habitat	28	39	**67**

- **Voters strongly support a variety of mechanisms to support conservation in Kentucky.** Survey respondents were also presented with several other ways to support conservation in Kentucky, from dedicating portions of existing taxes to providing tax credits for land donations. For example, four in five (82%) expressed support for "providing state tax credits to those who voluntarily donate land for conservation purposes." Additionally, at least seven in ten supported dedicating some portion of existing sales taxes or gas and oil extraction taxes to fund land and water conservation in Kentucky.

- **Kentucky voters' support for conservation is strong despite significant concern about economic issues.** Strong support for each of the potential approaches to funding and/or promoting land and water conservation in Kentucky comes despite voters' grave concerns about the economy. For example, nine in ten survey respondents indicated that "jobs and the economy" (90%) and "the price of gasoline" (89%) were "extremely" or "very" serious problems facing Kentucky. This is likely due to the fact that the vast majority of voters believe that a strong economy and clean environment are not in conflict with each other. When presented with two different statements about the relationship between the environment and the economy, three-quarters (74%) of survey respondents agreed that Kentucky can have a "clean environment and a strong economy at the same time" (Figure 6). This sentiment is shared by voters across the ideological spectrum, including two-thirds (66%) of conservative Republicans and 63 percent of those who support the Tea Party.



Overall, the survey results show that Kentucky voters value conservation, and in particular say it is important to protect the state's water, wildlife habitat, and working farmlands. Despite significant concerns about the economy – particularly jobs and gas prices – voters are highly supportive of additional funding to support land and water conservation in Kentucky.

Creating Long-Term Reliable Public Conservation Funding in Kentucky

The foundation of an effective statewide land conservation approach is a strong fiscal commitment on the part of state government through a stable revenue source. Substantial state investment will help

foster a comprehensive, transparent and accountable program that can sustain and grow the economic benefits that conservation provides.

Overwhelmingly, Kentuckians recognize the link between a healthy environment and a strong economy. While the Kentucky Heritage Land Conservation Fund and Purchase of Agricultural Conservation Easement programs have achieved substantial success in the last decade, Kentucky ranks below the national average for state investment in land conservation. Between 1998-2008, Kentucky spent only $11 per capita on land conservation and conserved just over 52,000 acres.[16] During that same period, Tennessee spent $20 per capita and conserved over 100,000 acres[16] and Virginia spent $109 per capita and conserved over 550,000 acres.[16]

If future generations are to enjoy and experience the natural places that enhance our lives and sustain our economy, we must create long-term and reliable conservation funding in Kentucky. We must recognize that the parks, trails, and open spaces in our communities provide jobs, help clean our air and purify our water. These areas provide recreation opportunities and improve the health of Kentuckians of all ages. Yet our tax code and policies have led to a drastic underfunding of programs to conserve our lands and waters. This places Kentucky in a competitive disadvantage in terms of attracting skilled workers and businesses that value the livability of communities and access to parks, trails, and waterways. The modernization of Kentucky's tax code must establish reliable and dedicated sources of revenue that provide a stable source of funds to ensure a vibrant economy through conservation and stewardship of Kentucky's streams and rivers, natural areas, and agricultural lands.

Prepared by Terry Cook, Kentucky State Director of The Nature Conservancy.

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For information on *Conserve Kentucky* visit www.conservekentucky.org

Endnotes

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Vulcan
Materials Company

December 5, 2012

Dear Governor's Blue Ribbon Tax Reform Commissioners,

We are writing this letter to protest the recent decision to add Proposal 59 to the Governor's Blue Ribbon Tax Reform. Proposal 59 would provide for the elimination of the export credit under the minerals severance tax rules in the State of Kentucky.

Our primary objection to this legislative change relates to the negative impact it has on our ability to maintain competitive market share on out-of-state sales, primarily in the Lower Mississippi River markets. Our location on the river and transportation logistics allow our Grand Rivers quarry to exceed the 60% threshold for out-of-state shipments more-often-than-not during each calendar year. The offsetting credit on the gross value of that stone export allows our company to be competitive with other producers on the river and with local resources downstream.

The elimination of this credit would greatly increase severance tax to our business annually, which would negatively impact our costs and ability to provide competitive pricing to external markets outside the state of Kentucky.

Without the cost benefit provided by this exemption, Vulcan would lose sales into these markets. We believe this would work to negatively impact Kentucky's economy, as loss of market share outside the State would increase our costs to produce, risking employment opportunities for Kentucky's workforce, and our ability to stimulate the local economy. Our Grand Rivers quarry employs anywhere from 150 to 250 employees during a calendar year, and we value the work of each and every one of these employees.

Please reconsider the action to add Proposal 59 to the recommended list of legislative changes during the session beginning 2013.

Sincerely,

Sherrod B. Clarke

Sherrod B. "Mike" Clarke, Jr.
Vice President/General Manager

SOUTHERN AND GULF COAST DIVISION, VULCAN CONSTRUCTION MATERIALS, LP
P.O. BOX 385016 • BIRMINGHAM, ALABAMA 35238-5016

Appendix R

The Commission voted against the following proposals:

Individual Income Tax

- Add additional tax rates for higher income individual on the income tax.
- Make taxable income equal to the federal Adjusted Gross Income (AGI) less a significant standard deduction and tax credit for low income households.
- Remove the spousal division on income and deductions.
- Create a tax credit for families that homeschool.
- Eliminate state income taxes for anyone not required to file a federal form.

Corporate Income Tax

- Allow companies that are approved for state corporate tax credits under the state's incentive programs to sell those credits on the market to other companies that can utilize them to offset their state corporate tax liability.
- Create a tax credit for businesses that support private and public schools.
- Eliminate capital gains tax for any early stage company that is headquartered in Kentucky
- Replace the Corporate Income Tax and LLET with a Gross Receipts tax or with some other sources of revenue.
- Require combined reporting for corporations.
- Review tax incentives or loopholes for the coal industry.
- Change the definition of taxable business income to mean "all income which is apportionable under the Constitution of the United States".
- Repeal the LLET on businesses experiencing a net loss.
- Exempt business-to-business transactions, including the purchases of business inputs used for the manufacture of goods.

Sales and Excise Tax

- Charge sales tax only on materials used to build a manufactured home, or 50 percent of the retail cost.
- Exempt business purchases of utility services.
- Extend sales tax to the auction price of a thoroughbred horse.
- Remove the sales tax from livestock antibiotics.
- Implement a back-to-school sales tax holiday.
- Impose a gross receipts tax of up to 3 percent for residential utilities.
- Impose a sales tax on food for consumption at home.
- Raise the sales tax.

Property tax

- Allow school districts to maintain the current property tax assessment rate even when the new assessment surpasses the four percent cap.

- Eliminate personal property taxation.
- Increase funding for PVA offices, or create a dedicated funding stream for PVA offices.
- Make private, nonprofit industrial development corporations in purchasing and developing land for business attraction, job creation and capital investment exempt from ad valorem taxes on their real estate holdings.
- Remove the property tax from aviation.
- Amend the Constitution to eliminate the homestead exemption for those over 65 while putting in place a statutory means-tested property tax circuit breaker for those over 65.

Severance Tax

- Raise the rate on the Coal Severance Tax.

Other Taxes/Issues proposals

- Eliminate Tax Increment Financing programs (TIFs).
- Establish a Kentucky estate tax with modest exemption limits.
- Sunset or provide regular review of tax incentives.
- Broaden the hospital provider tax to include doctors.
- Eliminate the estate tax.

Road Fund

- Modify the index in the gas tax rate to tie it to the inflation rate of transportation infrastructure construction costs.

Local taxation issues

- Allow all classes of local governments to have a local option food and beverage tax.
- Switch to a statewide restaurant tax of one percent instead of localities having different restaurant taxes.
- Allow single sales factor apportionment as a defined option to the city/county business tax calculation.
- Eliminate or limit (1%) occupational tax for counties less than 30,000.

Simplicity, Compliance and Tax Administration

- Create a uniform occupational tax statewide form.
- Eliminate the requirement forcing taxpayers to file a bond prior to appeal to Circuit Court. Extend the number of days to protest an assessment to at least 60 days and preferably 90 days.
- Make LLC members personally responsible for all taxes & make corporate officers personally liable for motor vehicle usage tax.
- Sales tax successor liability to enhance the Department of Revenue’s collection efforts.