KENTUCKY COMPETES: A Modern Tax Code that Creates Jobs

Governor Steve Beshear has made improving Kentucky's economy his number one priority. From reforming Kentucky's tax incentives to attract and protect quality jobs, to leading the nation in education and health reforms so that businesses have the workforce they demand, his leadership is bringing Kentucky out of the global recession stronger than ever, and has prepared us to tackle the challenges of the 21st Century. However, Kentucky's outdated tax code, created for a goods-based 20th century economy, holds the state back in its efforts to provide the Commonwealth with the economy it needs and deserves. Businesses have become acutely aware of the interdependency between state tax policy and future success. Kentucky competes with other states and countries on business location and expansion decisions, so it is imperative that we make the long-overdue modifications to our tax code to put the Commonwealth in a position to better compete in the attraction and retention of jobs.

Gov. Beshear proposes to modernize our tax code to make Kentucky more competitive and help attract jobs throughout the Commonwealth. The Beshear plan would:

Create a Tax Code that Competes for Quality Jobs

In order to create a business-friendly tax code that is attractive to business leaders as they are making decisions about where to locate and expand their businesses, Gov. Beshear proposes the following changes:

- **Reduce individual income tax rates.** Recognizing that four of our six neighboring states have lower top rates, and that corporate executives look at these rates when considering where to locate their businesses, Gov. Beshear's proposal would lower the top rate from 6% to 5.9% and reduce the number of rate brackets. While most low income filers will be unaffected because of the state's existing Family Sized Tax Credit and many will benefit because of a proposed Earned Income Tax Credit (see below), a small number could face a small increase by the elimination of the 2 and 3 percent brackets. Therefore this proposal includes a Hold Harmless credit that would ensure that no Kentucky taxpayer is negatively impacted by the elimination of those rate brackets.

  When coupled with the existing Family Sized Tax Credit and the proposed EITC and Hold Harmless credit, every Kentuckian will benefit from this rate change proposal.

Current Rate Structure		Proposed Rate Structure	
Adjusted Gross Income	Current Rate	Adjusted Gross Income	Proposed Rate
$0-$3,000	2%	$10,000 or less	4.0%
$3,001-$4,000	3%		
$4,001-$5,000	4%		
$5,001-$8,000	5%		
$8,001-$75,000	5.8%		
$75,001 and over	6%	$10,000 to $50,000	5.5%
		$50,000 to $100,000	5.75%
		$100,000 or more	5.9%

Surrounding states have the following rates:

- Illinois: 5%
- Indiana: 3.4%
- Missouri: 1.5% to 6%, with income over $9,000 taxed at 6%
- Ohio: .587% through 5.925%, with income over $208,500 taxed at 5.925%
- Virginia: 2% to 5.75%, with income over $17,000 taxed at 5.75%
- West Virginia: 3% to 6.5%, with income over $60,000 taxed at 6.5%

Fiscal impact upon full implementation: -$180.1 million

- **Enact a Refundable Earned Income Tax Credit (EITC) at 7.5 percent of the federal credit**. So that low-wage earners see tax relief, Gov. Beshear proposes that the state enact an EITC at seven and one-half percent of the federal EITC. The federal credit was enacted in 1975 and applicants must be working to qualify. The value of the credit depends on family size and income level. Indiana, Illinois and Virginia all have an EITC. Approximately 424,000 Kentucky taxpayers qualify for the Federal credit, so the same number would also be eligible in Kentucky. Research has shown that these credits are reinvested in local communities and help stimulate the economy. Upon full implementation the average credit for Kentuckians would be $171.50.

  Fiscal impact upon full implementation: -$72.75 million

- **Lower the top corporate income tax rate from 6.0 percent to 5.9 percent**. Gov. Beshear proposes to lower the top corporate rate to improve competitiveness for job creation and retention. Lowering our top corporate tax rate will mean that Kentucky's rate is lower than all but one of our neighboring states. Kentucky's neighboring states' rates are as follows: Illinois: 9.5%, Indiana, 8.5%, Missouri: 6.25%, Ohio: 0%, Tennessee: 6.5%, Virginia: 6%, and West Virginia: 7.75%. This plan will also lower the individual income tax rates as well (see above), and economists recommend that states have the same top corporate and individual rates.

  Fiscal impact upon full implementation: -$6.4 million

- **Phase-in single factor apportionment based solely on sales for corporation income tax, over a three-year period; Change the existing cost-of-performance based formula for apportioning sales to incorporate a destination sourcing for services.** Businesses in Kentucky that operate in multiple states currently determine their corporate income based on a three-factor formula of sales, property and payroll, with sales double-weighted. By switching to a formula that is based solely on sales, multi-state companies with a significant physical presence in Kentucky that includes lots of payroll and property will see a significant tax savings, including large manufacturers and companies headquartered in Kentucky. Approximately 18 other states have switched to a single factor formula based on sales. Single-factor apportionment is a prominent signal to prospective businesses that Kentucky is serious about increasing our growing industrial presence. Single-factor also provides incentive for companies to have more payroll and property in Kentucky, since future apportionment will be on the basis of sales, not plant and payroll. Presently, a multi-state business must apportion income to Kentucky for taxation based on a formula that assigns sales from services to KY if the greater cost of performing the service occurs in KY. Many businesses find this formula to be a disincentive to create or maintain jobs in this state. Therefore, in addition to switching to a single factor apportionment, the Beshear Administration proposes to assign sales from services to KY only if the final destination of the service is in KY. Market-based sourcing will further solidify Kentucky's policy decision to not penalize businesses with substantial investments and employees in Kentucky.

  Fiscal impact upon full implementation: -$154.5 million

- **Create an angel investor tax credit for certain investments in small businesses**. In order to attract capital investment in the state and the creation of knowledge-based, high-tech start-up companies, Gov. Beshear proposes the creation of an angel investor tax credit, to be capped at $3 million. Under this proposal, individual investors could receive a non-refundable individual income tax credit of up to $200,000 a year for certain investments in these types of businesses. Many other states have an angel investor tax credit, including Colorado, Georgia, Hawaii, Illinois and Minnesota.

  Fiscal impact upon full implementation: -$3 million

- **Expand the state's R&D Tax credit to human capital**. Kentucky currently has a research and development tax credit, but it is linked to construction. This proposal would expand the existing credit to human capital, such as salaries, or consultant and research activity expenses.

  Fiscal impact upon full implementation: -$4 million

- **Double the New Markets Tax Credit.** Kentucky must ensure opportunity and ability to invest in small businesses in Kentucky communities, including low-income communities. Gov. Beshear proposes to double the amount of funding available, from $5 million to $10 million each year, for New Markets Tax Credits, a credit for persons or entities that purchase a qualified equity investment from a community development entity.

  Fiscal impact upon full implementation: -$5 million

- **Exempt inventory from state property tax (merchant's inventory, manufactured finished goods, and goods stored in warehouse)**. Kentucky taxes several types of inventory under the property tax, and inventory is taxed at different rates. This proposal would exempt certain inventory from the state property tax.

  Fiscal impact upon full implementation: -$7.2 million

- **Eliminate selected negligible state property tax rates for tangible personal property, with an emphasis on classes of property subject to the "State Rate" only**. Kentucky tax rates for some personal property are extremely low. This proposal seeks to eliminate state taxation of certain classes of property, in part because they cost more to collect than they generate. These classes are:

  - Manufacturer's Raw Materials/ Goods in Process
  - Motor Vehicles Held For Sale Dealers Only
  - New Farm Machinery Under Floor Plan, New Boats & Marine Inventory Dealers Only
  - Unmanufactured Tobacco Products not at Plant or in Hands of Grower or His Agent
  - Other Unmanufactured Agriculture Products not at Plant or in Hands of Grower or His Agent
  - Unmanufactured Agricultural Products at Plant or in Hands of Grower or His Agent
  - Aircraft: Non-Commercial
  - Watercraft: Non-Commercial
  - Livestock & Farm Machinery/ Fluidized Bed Energy Facilities
  - Foreign Trade Zone

  Fiscal impact upon full implementation: -$5 million

Help Kentucky's Signature Industries Thrive and Expand

Kentucky should have a tax code that helps its signature industries thrive – not stand in the way of their progress and their ability to create more jobs. Therefore Gov. Beshear proposes to:

- **Create an income tax credit for the bourbon industry - must be reinvested in facilities and equipment.** The distilled spirits industry, especially bourbon, has become a growing signature industry in Kentucky. This proposal would create an income tax credit for Kentucky's signature bourbon industry to offset the property tax on stored barrels of bourbon, without reducing local property taxes to school districts or local communities.

Companies would be required to reinvest the tax savings in facilities and equipment, thereby improving their competitiveness.

Fiscal impact upon full implementation: -$13.3 million

- **Exempt the sales and use tax on certain equine products to support the signature equine industry - similar to all other livestock.** Kentucky's signature horse industry is a $3 billion industry with approximately 41,000 jobs and it faces tremendous competition from states across the nation. This proposal by Gov. Beshear would provide a sales tax exemption for equine-related agriculture expenditures, exemptions that are already available for other livestock, including hay, feed, feed additives, watering systems, equine grooming supplies, straw, seed and fertilizer applied to pastures.

  Fiscal impact upon full implementation: -$14.8 million

- **Exempt the sales tax on pharmaceuticals for food animals.** Recognizing the critical role that our agriculture producers play in our economy and in our food production, Gov. Beshear proposes to exempt pharmaceuticals for food animals. By eliminating the sales tax on food animal pharmaceuticals, our livestock producers, growers and animal health providers will become more competitive with their counterparts in surrounding states and our region of the country. This investment will lead to increased economic activity throughout rural Kentucky.

  Fiscal impact upon full implementation: -$4.8 million

- **Lower the wholesale tax on beer, wine and distilled spirits**. Kentucky is the only state to have a wholesale tax on wine; Kentucky and Tennessee are the only two states that have a wholesale tax on beer; and Kentucky and South Carolina are the only two states that have a wholesale tax on liquor. This proposal would lower the 11% wholesale tax on beer, wine and distilled spirits, to 10% over a three year period.

  Fiscal impact upon full implementation: -$16 million

- **Repeal the distilled spirits case sales tax**. Currently the distilled spirits industry is unfairly taxed with a case sales tax. Other types of alcohol in Kentucky do not have a similar case sales tax. This proposal would repeal this unfair tax.

  Fiscal impact upon full implementation: -$100,000

Create a Healthier and More Productive Kentucky Workforce to Attract Jobs

Decision makers in the corporate world consistently say that a quality workforce is one of the primary, if not the primary, factor a company looks for when deciding where to locate a new business or expand an existing one. Gov. Beshear has made improving the overall health of Kentucky's workforce one of his administration's priorities. In order to continue improving the workforce, Gov. Beshear proposes to reform the tax code by:

- **Increase the tax rate on cigarettes to $1.00 and increase the tax rate on other tobacco products (OTP) commensurate to the cigarette tax increase, and tax e-cigarettes at 20% of value.** Kentucky's current tax on cigarettes, 60 cents per pack, remains well below the national average and in the middle of the pack, compared to our neighboring states:

National average:	$1.46 per pack
Ohio:	$1.25 per pack

Indiana:	$.995 per pack
Illinois:	$.98 per pack
Tennessee:	$.62 per pack
Kentucky:	**$.60 per pack**
West Virginia:	$.55 per pack
Virginia:	$.30 per pack
Missouri:	$.17 per pack

This proposal, to raise the cigarette tax to $1.00, will have health benefits for every Kentuckian, and studies show that it will particularly impact children and pregnant women who smoke. In addition this proposal would raise the tax rate on other tobacco products, which present similar health problems to our citizens, a commensurate amount. This would include e-cigarettes, a new nicotine-delivery system that has begun to garner a larger share of the market, and one which presents unique health challenges. Currently, only Minnesota taxes e-cigarettes.

Fiscal impact upon full implementation: $124.5 million

- **Restore the Cigarette Rolling Papers Tax**. This proposal was already passed by both chambers of the Kentucky General Assembly in 2008, but later stricken by the courts because it was delivered to Gov. Beshear past the midnight hour on the final day of the legislative session.

  Fiscal impact upon full implementation: $800,000

Modernize Tax Code to Acknowledge Changes in the Economy & Technology

- **Broaden the sales tax to include selected services**. Kentucky long ago moved from a goods-based economy to a service-based economy. However, our tax code has not kept up with this transition. In 1960, consumer expenditures on goods represented 53.4 % of total, personal expenditures made by Americans. By 2012, goods had dropped dramatically to only 33.8 % of these expenditures. Conversely, in 1960, consumer expenditures on services represented 46.6% of total, personal expenditures made by Americans. By 2012, services represented 66.2% of personal consumption expenditures. This change in how consumers spend their dollars has eroded Kentucky's sales tax base. Kentucky currently taxes some services. This proposal would expand sales taxes to the labor associated with the installation and repair of taxable goods, certain recreational activities, certain commercial and residential services, and several personal services. See attached listing.

  Fiscal impact upon full implementation: $279.9 million

- **Clarify that the sales tax is applicable to all prewritten software, regardless of method of delivery.** This proposal seeks to clarify that the sales tax is applicable to all prewritten software, regardless of method of delivery. Kentucky applies the sales tax to all prewritten software, including software that is sold as a tangible product, and software that is downloaded. Because of technological advancements, customers can now access the software on the digital cloud. This proposal will preserve Kentucky's existing tax base on the retail sale of prewritten computer software by clarifying that this method of delivery is also taxable.

  Fiscal impact upon full implementation: $5 million

- **Apply sales tax and transient room taxes to the entire hotel accommodation price**. Many people now purchase hotel rooms via online websites. The change in available technology has resulted in reduced revenues for both state and local governments. This modernization proposal makes clear that all amounts paid for staying in a Kentucky hotel or similar accommodation, including any amounts charged or retained by online travel companies for their services, are included in the tax base for the sales tax and state and local transient room taxes.

Fiscal impact upon full implementation: $4.7 million

Modernize Code to Acknowledge Changing Demographics and Differences with Other States

- **Reduce retirement income exclusion for taxpayers with a federal AGI over $80,000 and phase it out for AGI over $100,000.** Most states that levy a personal income tax allow people who receive retirement income to exclude part of it from their taxable income. 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. With the aging of the population, the amount of retirement income in the economy will be growing over time. With the exception of Illinois, Kentucky is out of sync with most of its neighboring states, which tax more pension income than Kentucky:

  Indiana: Private and public pensions are taxed with no exemption.
  Missouri: Taxes social security according to a schedule that rose to 100% deductibility in 2012, as well as public pensions.
  Ohio: All retirement income is taxed, subject to a $200 tax credit.
  Virginia: $12,000 pension exemption amount.
  West Virginia: No exemption for private pensions; full exemption for state and local public safety employees.

  This proposal would impact Kentucky's higher income pension earners, reducing the exclusion for those with an adjusted gross income over $80,000 and phasing it out for AGI over $100,000. 90,200 filers would be impacted by this proposal. Social security benefits are currently <u>not</u> taxable in Kentucky and would <u>not</u> become taxable under this proposal.

  Fiscal impact upon full implementation: $176.3 million

- **Phase out the $10 Individual Income Tax Credit.** In 1960, a $20 personal credit was created for every taxpayer, regardless of income. In 2013, this was lowered to $10. This proposal seeks to phase out the remaining $10. Tax relief for low-wage earners is provided by the state's current Family Size tax credit. In addition, Gov. Beshear is proposing an EITC. Therefore, this credit is outdated and unnecessary. The existing tax credits for National Guard members, blind individuals, and senior citizens would be maintained with no change.

  Fiscal impact upon full implementation: $32.8 million

- **Require same income tax filing status for married couples at state level as federal level.** Currently, spouses may file a joint return, file separate returns, or file separately on a combined return. Kentucky is one of only a handful of states that permit this third filing status, as the two-column return adds further complexity to filing an income tax return. None of our surrounding states allow spouses to file separately on a combined return. This proposal would eliminate the option to file separately on a combined return. 430,000 filers would be impacted by this proposal.

  Fiscal impact upon full implementation: $72.8 million

CONCLUSION

COMPETING FOR EVERY JOB: Every family and every community deserve quality, good-paying jobs. One of the most important tools to attract and retain those jobs is a state's tax code. It is critical that Kentucky modernize, simplify and improve our tax code so that it can compete with any location, anywhere in the world, for the jobs that it needs and deserves. This plan proposes significant changes to help attract these jobs, from changes targeted toward corporate executives to targeted assistance to the Commonwealth's signature industries. Most notably, the proposed change to single-factor apportionment and market-based sourcing will have an immediate resonance with the business community.   To that end, the disincentive to have property and payroll in Kentucky would be removed, marginal tax rates lowered, and classes of property exempted. Gov. Beshear's plan also uses the tax code to help create a healthier Kentucky workforce, so businesses know they can count on workers who will show up and do the job, free of the historical health problems that have long plagued the state.

A MODERN CODE THAT GROWS WITH THE MODERN ECONOMY: If Kentucky is to have an elastic tax code that grows appropriately with the economy, it must acknowledge changes in the economy. This plan, with a broadening of the sales tax to selected services, recognizes that Kentuckians are purchasing more services and fewer goods, and will allow Kentucky's tax revenue to grow as the economy grows. The selected services were identified as good candidates because they are tied to the purchase of goods or services in Kentucky. The tax plan specifically does not seek to expand the sales tax to certain professional services that could easily move across our borders.

REVENUE INCREASE HELPS RELIEVE THE STRUCTURAL IMBALANCE: This plan restructures the tax code to reduce tax rates and broaden the tax base in several ways. This plan generates an estimated $210 million upon final implementation. This close to the amount of Kentucky's structural imbalance – the amount of one time funds the state uses to pay for recurring expenses. While this is the short term estimate, long term this plan will improve the performance of the overall tax system as the economy grows.

Kentucky's tax code holds it back from having the economy that it needs and deserves. It is archaic, unfair, and stands in the way of greater success. This plan, if fully implemented, will change that.