Legislative Briefing

Governor Fletcher's
JOBS and
OPPORTUNITY
BIPARTISAN
SOLUTION
for Kentucky

Ernie Fletcher
Governor

Bradford L. Cowgill
State Budget Director

TABLE OF CONTENTS

APPENDICES

Jobs and **O**pportunity **B**ipartisan **S**olution for Kentucky

The Fletcher proposal to modernize Kentucky's tax code, *JOBS for Kentucky*, is anchored by a guiding principle: make the Commonwealth more competitive and create jobs. Many leading economists have concluded that Kentucky's top marginal tax rates facing individuals and businesses are too high to foster economic prosperity. High marginal tax rates provide disincentives to supply labor and earn income in Kentucky. Moreover, they discourage business recruitment and business retention. Lower marginal tax rates on individual and business incomes will enhance the economic climate in Kentucky and create incentives for consumption, employment, and income. As the government poses fewer obstacles to the economy, it will in turn benefit from a more stable, predictable, and elastic revenue stream.

The problems with the current tax code are well known. The current debate began in earnest with the Commission on Tax Policy in 1995. Over the past several years, the focus has been on bringing Kentucky's tax code in line with current economic and budgetary realities. The economy, the courts, demographics, neighboring states, the federal government, and the taxpaying community demand a change in our system of finance. The *JOBS for Kentucky* proposal responds to these demands.

Kentucky's most important source of revenue is the individual income tax. Despite the fact that Kentucky's individual income tax places a heavy burden on low-income citizens, the state relies more heavily on it every year. Individual income tax revenue as a percent of total General Fund receipts, has increased from 30.1% in 1981 to 41.2% in 2003. Kentucky state and local governments rely much more heavily on the taxation on individual income than the norm around the U.S.[1] And because the individual income tax is the most elastic of the General Fund taxes, an increased reliance on this tax raises the volatility of state tax collections.

[1] *Report to the Sub-Committee on Tax Policy Issues*, Committee on Appropriations and Revenue, Kentucky General Assembly, William F. Fox, February 27, 2002. p. 3.

Second in importance is the sales and use tax, which raises 35% of General Fund receipts. Riddled with exemptions and exclusions, the sales tax code creates confusion among taxpayers and poses a compliance burden for taxpayers and administrators alike. Enacted nearly a half-century ago, this tax reflects the economy of its time. Today's technologically advanced economy generates new products and services at an alarming rate, but the tax code cannot incorporate them. As Kentuckians shift spending habits toward services rather than physical goods, and purchase an increasing amount of items remotely via the Internet and catalog sales, the divide between the tax code and consumption grows. Today, the sales tax base is less than half of the state's Gross Domestic Product, and its growth continues to lag behind the economy.

Kentucky's business tax code also reflects old ways of doing business. Certain tax laws differentiate between businesses according to their legal structure, which creates incentives to organize for tax purposes. Different rates and apportionment formulas create opportunities for aggressive tax planners to legally avoid taxation in Kentucky, forcing other business entities to shoulder the entire load. The corporation license tax is universally unpopular and is restrictively applied. In the telecommunications industry, companies comply with a hodgepodge of state and local taxes that treat producers of similar, competing products and services differently. The existing structure is uncompetitive and unfair, both for consumers and the providers of these products and services.

Even the state's property tax policy reaches back in history, to a time when hyperinflation wreaked havoc on the tax base. House Bill 44, enacted in 1979, allayed the public's fears of unrestrained taxes. A quarter century later, HB44 continues to hold the reins, long after inflationary concerns have subsided. As a result, property taxes have fallen from 9.5% of the General Fund in 1981 to 6.6% in 2003. Property taxes can be a source of stable, yet reliable growth, but antiquated constraints force government to finance public services with less reliable and more volatile sources.

Overall, Kentucky's tax laws have not kept pace with a continuously modernizing world. This widening gap between the modern economy and Kentucky's tax code has led to an increasingly inefficient and unfair stream of revenue. Governor Fletcher is committed to eliminating wasteful spending in state government and has proposed a lean budget fundamentally configured so that the state can live within its means. Similarly, this proposal to modernize the state's tax structure proposes no increase in taxes. Instead, this tax reform package addresses many of the inequities, inadequacies, and inconsistencies in the state's tax structure in order to make Kentucky competitive.

Tax reform studies

In recent years, **several studies have addressed inadequacies in the state's revenue structure**, the most notable of which resulted from the 1995 Kentucky Commission on Tax Policy. The forty-seven-member commission offered a set of revenue neutral recommendations that "would radically restructure Kentucky's Tax Code, creating a new system that is vastly more simple, more fair, more competitive for business growth, and which produces a more stable flow of revenue than the present system."[2]

In the five years following the Commission's report, the Commonwealth enjoyed a period of strong economic growth during which several of the revenue reducing measures recommended in the Commission's report were adopted. Other tax cutting measures were enacted in this period as well and further reductions in state taxes were directed by the courts. However, the Commonwealth never adopted measures recommended by the Commission to broaden the tax base.

Significant debate on tax policy took place in the 2000 Session of the General Assembly when it was proposed that the legislature revisit the remaining components of the 1995 Commission study. The

[2] *A Blueprint for Comprehensive Reform*, Kentucky Commission on Tax Policy, November 15, 1995, p.1.

2000 General Assembly did broaden the sales tax base to include interstate long distance phone calls, but reached no agreement on significant changes to the tax structure.

The 2001 General Assembly adopted House Joint Resolution 30, which created a Subcommittee on Tax Policy Issues of the Interim Joint Committee on Appropriations and Revenue. The subcommittee's charge was to study the Kentucky tax code over the interim and make recommendations to the 2002 General Assembly. The Subcommittee commissioned Dr. William Fox, Professor of Economics and Director of the Center for Business and Economic Research of the University of Tennessee to study Kentucky's tax structure.

Dr. Fox's report addressed the performance of the tax structure's ability to finance state government and its impact on family tax burdens and business competitiveness. The Fox Report reached many of the same conclusions as the 1995 Commission on Tax Policy and suggested policy options to bring growth, competitiveness, simplicity, and fairness to the tax code. Nevertheless, no significant action was taken in either the 2002 or 2003 Sessions.

JOBS for Kentucky addresses many of the recommendations made by the 1995 Kentucky Tax Policy Commission and the Fox Report. Among the recommendations made by the Tax Policy Commission that are included in this plan are to lower the top corporate income tax rate, restrict filing options (consolidated vs. separate filing), and limit the net operating loss of corporations to be carried forward only. The Commission also recommended altering the structure of the corporate license tax, which is being done by eliminating the tax. The Fox report contained the recommendation to tax LLCs like corporations and to broaden corporate nexus to a "doing business standard, both of which are included in the proposal.

Both studies recommended alterations to House Bill 44 to address the continuous slide in real property tax rates. The Commission Study also called for repealing the intangible property tax. These are both components of *JOBS for Kentucky*. The plan also achieves several other recommendations in the Fox report, including imposing sales tax collection requirements on internet affiliates of retailers with Kentucky presence, raising both the cigarette and alcohol excise taxes, and reforming communications services taxes.

Appendix A contains a detailed comparison of the recommendations made in these prior tax reform studies to the recommendations in this plan.

Fletcher goals of tax modernization

The primary goal of *JOBS for Kentucky* is to make Kentucky competitive by removing obstacles to innovation and investment in the Kentucky economy. Because individuals and entities that create wealth can choose where they want to locate, Kentucky's tax code needs to be competitive with its neighboring states. Government cannot create economic growth; it *can* foster an environment that creates opportunities for entrepreneurs and workers to succeed. To do this, the tax code should be re-written to:

- Attract and retain human capital to the state such that Kentuckians can build and sustain better careers and families;
- Create a more business friendly environment;
- Reduce taxes for a majority of Kentuckians;
- Increase the responsiveness of the tax system to growth in the economy;
- Make changes that are revenue neutral initially with elements that will spur economic growth in the future; and
- Export some of the tax burden to non-residents.

***JOBS for Kentucky* is NOT a tax increase**

What makes this proposal so effective is the assurance that it gives to Kentuckians that state government will not continue its historical growth and that overall, taxes will not increase. ***JOBS for Kentucky* is revenue-neutral**, and with good reason. The innovative capacity of individuals and private companies has been, and will always be, the key to Kentucky's prosperity. Government should fund its obligations to meet necessary public services, but no more. This plan balances any tax increases with offsetting tax reductions, and in the process, limits state government's presence in the decisions of Kentucky households and businesses. In addition, the plan includes a mechanism for further reductions in the individual income tax rates in subsequent years if, but only if, projected economic expansion (and the resulting government revenue) grow more rapidly than inflation and the population. This mechanism will ensure that Kentucky households, and not state government, will reap the lion's share of the benefit of economic expansion.

Principles of the proposal

Kentucky's tax code punishes economic expansion with high marginal tax rates and alters business and household location, investment, saving, employment and consumption decisions with discriminatory exemptions and differential tax rates. The solution, where possible, is to expand the base of taxation and lower marginal rates. Economists have long championed base broadening as desirable tax policy in that it reduces the instances where taxes alter relative prices, and therefore, consumption and production choices.

The erosion of the tax base results from a static set of tax laws intervening in a changing economy. Significant changes include decreases in the manufacturing and agriculture sectors, increases in the services sector, increases in multi-state business activity, and consumer spending shifts from taxable goods to non-taxable services. In addition, any tax policy changes that have been made have been undertaken in piecemeal fashion to create special exemptions, credits, or tax rates. These changes have resulted in a tax code that favors some economic choices over others. When households and businesses make decisions based on the tax consequences rather than the true market benefits and costs, everyone is worse off. The current tax code rewards those who spend resources on tax avoidance rather than efficient production and innovation. This modernization proposal focuses on areas of the tax code that promote such inefficiency.

The major financial and conceptual commitments arising from this fundamental premise involve reductions in marginal tax rates on income earned in Kentucky and the elimination of an onerous license tax on capital employed here. In an increasingly mobile and fluid economy, these taxes create an enormous impediment to the attraction of new income and capital formation. These reductions are coupled with other adjustments in the individual income tax to provide needed income tax relief to low-income Kentuckians, since the same studies referred to above note that Kentucky has an inordinate tax burden on the poorest of taxpayers. The reduction in these taxes would be offset by a combination of changes in other taxes that would raise revenue by closing loopholes that have been created over time, broadening the tax base, and addressing fairness and inconsistencies in the tax code.

Static versus dynamic revenue scoring

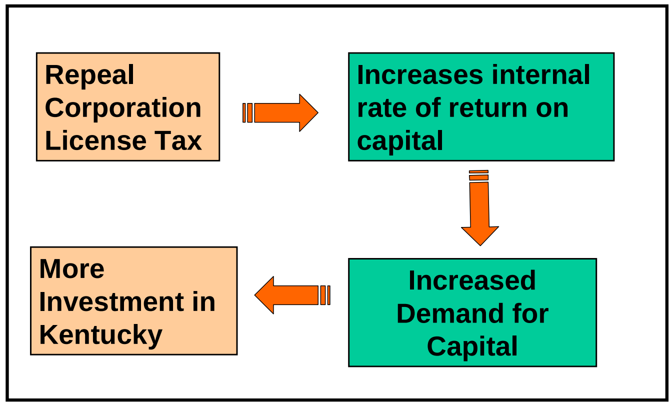
Static revenue neutrality implies that the net flow of taxes in the year of implementation should remain equal to the revenues projected by the Consensus Forecasting Group (CFG). In a static scoring process, it is assumed that income and employment are held at their baseline levels. When scoring the fiscal impact, a static analysis compares the income, employment, and revenue predictions of the CFG to the new revenue predictions resulting from the new tax policies, holding income and employment constant at the CFG levels.

Economic theory suggests, however, that marginal tax rates matter to decision-makers in businesses and households. This implies that the key assumption made in static analysis – that income and employment are held constant – should be revisited. Thus, when the behavior of consumers and businesses is expected to change, dynamic analysis is an appropriate tool to model whether the proposed tax law changes will have the desired effect of stimulating the economy. For example, a dynamic modeling system captures a household's response to the lower income tax rates in the choice between work and leisure. Businesses will respond to lower marginal tax rates by choosing Kentucky as a place to conduct business, invest in physical capital, increase production, and hire additional workers. The additional income then generates consumer and business spending, which creates further income and spending effects. Elimination of the corporation license tax increases the after-tax rate of return companies earn on investment, which induces more capital spending here in Kentucky (see Figure 1).

In turn, the increased capital stock expands productivity, creates income, and induces further spending. The same process works in reverse as the higher taxes on tobacco products and the negative effects of freezing the property tax rate reduce income in the economy. Our analysis uses the Regional Economic Models Incorporated (REMI) computer simulation model for Kentucky, a model employed by the Legislative Research Commission as well as other state agencies in Kentucky and by state agencies, consulting firms, and local governments throughout the country.

Figure 1

A Capital-Friendly Commonwealth



The *JOBS for Kentucky* plan makes several changes that create incentives for increased capital formation in the Commonwealth, not the least of which is a proposed repeal of the corporation license tax. Tax modernization will create an economic climate much more friendly to the formation of capital in the state. It should be noted that even though the overall impact of the taxes on business is roughly revenue neutral, the dynamic impact is positive within the realm of business taxes. The stimulative effect of repealing the corporation license tax and lowering the tax rates more than offsets the effect of including limited liability entities into the corporation income tax.

The actions having positive and negative dynamic impacts are listed in Figure 2.

Figure 2

Positive Dynamic Effects	Negative Dynamic Effects
Repeal of the corporation license tax	Alternative minimum calculation for business entities
Reduce rates on corporation income tax	Adding limited liability entities to corporation income tax base
Repeal property tax on intangible personal property	Removing new property from rate setting base on real property
Reduce rate on individual income tax	Raising cigarette taxes
Enterprise Initiative	Taxation of other tobacco products
Back-to-school sales tax holiday	Tax reform in telecommunications
Tourism advertising initiative	Impose transient room tax

In the dynamic scoring process, care was given to perform balanced-budgeting dynamic analysis. That is, the positive and negative dynamic impacts were modeled simultaneously in magnitudes such that the static revenue neutrality was preserved. However, some of the negative impacts, although they generate a large revenue gain in the static world, do not create similarly large dynamic drags on the underlying economy. For instance, one of the largest static tax increases is the increase in the excise tax on cigarettes. This was modeled in the dynamic model as an increase in prices for other non-durable goods; but given the low price elasticity of demand for most of the items in this category, there was not a large dynamic loss of output or employment associated with additional tax on cigarettes. The reductions to the rates on corporate and personal income, however, created larger dynamic impacts since the economic agents in the model responded more elastically to the relative changes imposed in the model.

The overall dynamic revenue impact is displayed in Figure 3. These estimates represent the amount of revenue expected from tax modernization over and above the amount projected by the Consensus Forecasting Group. As stated above, the overall static revenue neutrality does not include revenues generated through dynamic impacts. Rather, these impacts, and the accompanying economic analysis, underscore the fact that the tax modernization proposal creates a stimulative economic environment for revenue generation while simultaneously creating incentives that make Kentucky more competitive. Results from the dynamic analysis of the tax package confirm that employment and personal income, the key economic drivers, will be enhanced over time as the incentives created by tax modernization work through the economy.

The dynamic impact on employment is arguably even more profound than the revenue impact. One of the polestar objectives of tax modernization is to stimulate the economy and create better employment opportunities for citizens of the Commonwealth. Figure 4 demonstrates that *JOBS for Kentucky* does just that. During the first full year of implementation, the plan generates an estimated 6,359 jobs over the baseline employment number projected by the Consensus Forecasting Group. The number swells to over 6,800 jobs in the second full year of implementation. Simply put, the proposed changes in tax laws will create opportunities for more citizens to find work and keep a larger after-tax percentage of what they earn.

Figure 3

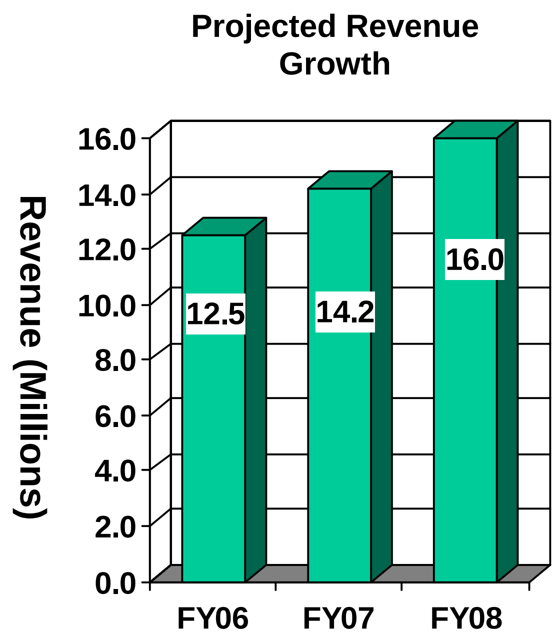
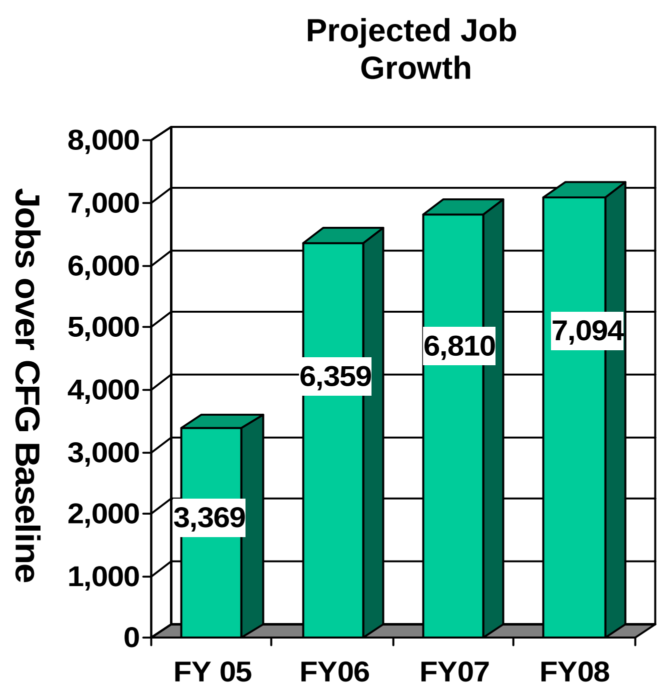


Figure 4

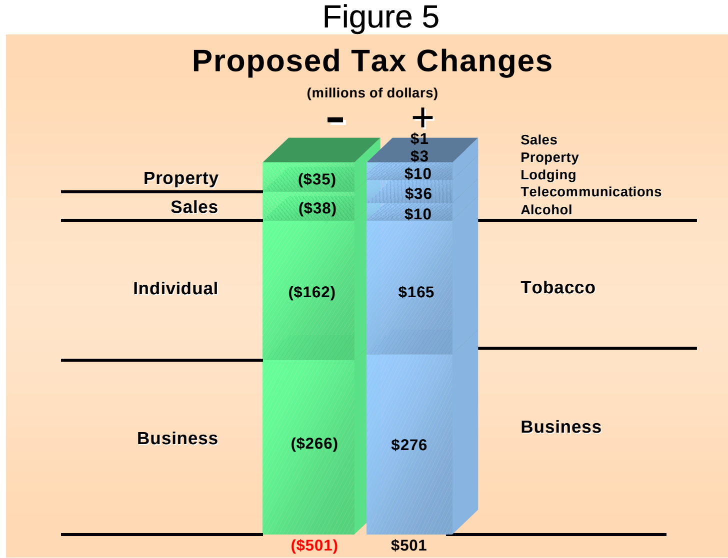


Components of the revenue neutral proposal

A revenue neutral tax package must, of course, offset tax reductions. This proposal offers significant tax reductions in individual income, business, sales and use, and property taxes that are necessary to modernize Kentucky's tax structure. Both the household and business sectors share in these tax reductions. Overall, the plan provides $501 million in tax relief over the biennium.

To offset these decreases, the plan raises $501 million in General Fund revenues over the same period. First, the plan proposes substantial changes in the way Kentucky taxes business activity and, in doing so, redistributes the current burden on business more efficiently and equitably. The reengineered approach to taxing businesses results in a lower rate of taxation with a broadened base to bring competitiveness and fairness to the structure. Changes to the rate-setting mechanism in the real property tax bring modest revenue gains. In addition, increases in user fees contribute to the revenue stream. Specifically, increases in the taxation of alcohol and tobacco products are proposed. Modernizing the manner in which Kentucky taxes the communications industry adds a modest amount to the General Fund. Finally, tourism development is supported through a lodging tax. Figure 5 depicts the offsetting nature of the proposed decreases and increases in the Kentucky tax structure.

Figure 5



The following section describes the proposed changes to each tax and the rationale for the changes. Appendix B offers detailed fact sheets on each of the proposals to provide additional information on Kentucky's competitive position relative to surrounding states, detailed fiscal impacts, and estimates of how taxpayers will be affected by the proposed changes.

Figure 6 provides a detailed fiscal summary of the proposed changes by tax type and the projected fiscal impact of each change.

Figure 6

Fiscal Summary of the Plan

	Fiscal Year		
	2004	**2005**	**2006**
Tax Changes			
Individual Income Taxes	--	-$96.2	-$161.7
Business Taxes			
Corporate License Tax Repeal	--	-$19.3	-$196.3
Income Tax Rate Reduction	--	-$24.2	-$69.6
Loophole Closing	--	$17.2	$66.1
Limited Liability Entity Inclusion	--	$22.3	$106.5
Alternative Minimum Calculation and Minimum Tax	--	$0.0	$103.3
Property Taxes			
Intangible Personal Property Tax Repeal	--	$0.0	-$35.3
Real Property Tax Rate Adjustment	--	$0.0	$3.4
Sales Taxes			
Kentucky Enterprise Initiative	--	-$5.6	-$30.4
Back-to-School Sales Tax Holiday	--	-$7.4	-$7.5
Sales Tax Nexus	--	$1.0	$1.0
Tobacco Taxes	--	$168.6	$164.9
Alcoholic Beverage Taxes	--	$8.3	$10.0
Uniform Excise Tax on Communications Services	--	$14.2	$35.6
Lodging Tax for Tourism Promotion*	--	$7.9	$9.9
Corporate License Tax Reduction Pending Repeal (ITW)	-$26.6	-$60.3	$0.0
Revenue Neutral Impact	**-$26.6**	**$26.6**	**-$0.1**
Additional Fiscal Impact			
Revenue resulting from JOBS for Kentucky**	--	--	$12.5
Additional revenue from non-tax impacts	**--**	**$0.0**	**$12.5**
Total	**-$26.6**	**$26.6**	**$12.4**

Notes:

* Revenues dedicated to a restricted fund

** General Fund revenue

Reducing individual income taxes

The **centerpiece of the proposal is to decrease the individual income tax burden** on Kentuckians, with two intended consequences: a reduced tax burden on the lowest income Kentuckians, and a lower top marginal income tax rate. A 2001 study by the Legislative Research Commission found that Kentucky's individual income tax burden on families in the lowest income quintile ranked 39th among the states and 38th for families in the second lowest income quintile.[3] Every year, Kentucky makes the short list of states with the most onerous income taxes on the working poor.

To address the needs of low-income families, *JOBS for Kentucky* proposes a significant expansion of the low-income credit, effectively removing the income tax burden on filers with less than $12,000 in income. As a result, approximately 125,000 households representing 300,000 Kentuckians will no longer owe any state income tax.

To address the disincentives created by a high top marginal rate, the proposal decreases the existing top rate of 6% to 5.68% with the intent to lower the rate further in the future. Nearly all households will see a small income tax reduction, and all of Kentucky will reap the long-term benefits as the lower rate keeps Kentucky competitive.

To broaden the income tax base, the proposal makes two minor changes to the way pension income is treated for tax purposes in Kentucky. First, the exemption of pension income in Kentucky currently allows filers with sizable pensions and a modest amount of other taxable income to qualify for the low-income tax credit. This qualification for the low-income tax credit was unintended and is eliminated in this proposal. Second, the pension exclusion would be frozen at its current level of $40,200 per taxpayer, rather than continuing to index it to inflation. This minor base broadening is consistent with sound economic principles of horizontal equity and fairness. The tax consequences for most will be minimal and will be targeted on the highest-income pensioners.

[3] Legislative Research Commission staff memorandum. September 28, 2001. Comparison of state and local tax burdens and government benefits for low-income families. P.11, 13.

The individual income tax portion of the Fletcher proposal represents the cornerstone of the proposal. Willingness to make this level of financial commitment to lowering tax rates underscores the importance of economic competitiveness to the Fletcher initiative. This will provide immediate relief to low-income Kentuckians, and it will send a strong signal to the business community that Kentucky is an ideal location for future growth and expansion.

In addition, the tax modernization plan makes several minor improvements to the income tax. First, it proposes to exempt from Kentucky income tax any future tobacco quota buy-out or buy-down payments. The plan addresses minor inconsistencies and unintended consequences in the income tax code by proposing to remove the deduction for foreign income tax paid and tighten the language in the recycling credit to prevent abuse of the tax benefit. Also, under the plan, individual owners of pass-through entities will continue to be taxed on their business income, but will receive a credit for their proportionate amount of entity-based tax paid. In addition, the plan modifies the treatment of banks' exclusion for franchise tax paid. Finally, the plan includes several proposals to modernize the administration and filing of income tax returns.

In addition to these changes in Kentucky's income tax, *JOBS for Kentucky* calls for the creation of a task force with representation from state government, local governments, schools, and independent businesses to study the methods of taxation used by Kentucky localities. The group will be asked to evaluate the existing tax landscape at the local government level and develop a proposal for the modernization of local taxation, with the stated goal to further remove impediments to the creation and formation of human capital, capital investment, and job creation within the Commonwealth.

Additional tax cuts

The Governor insisted that any plan of tax modernization satisfy two requirements:

- First, that it be **revenue-neutral and fulfill his pledge of no new taxes on Kentuckians.**
- Second, that any overhaul of Kentucky's tax code would stimulate the Kentucky economy, attract and retain human capital and promote an investment-friendly environment.

This plan fully satisfies those requirements. In the next biennium, the plan generates no additional revenue for state government—no new revenue, that is, unless and until the plan achieves its objective of stimulating the private sector and growing Kentucky's economy. When the plan is examined using a "dynamic scoring" model, it is possible to project the success of the plan's "stimulative" nature.

Because the plan removes obstacles to expansion and growth, the dynamic scoring model forecasts growth in the overall tax base in the out years. By lowering the top rate from 6% to 5.68%, as well as the promise of future reductions, this plan will make Kentucky more competitive.

Indeed, it is possible that the plan will be even more effective in stimulating jobs growth and economic activity than is now predicted. In order to be faithful to the principle of fiscal responsibility and the no-new-tax pledge, the plan contains a revenue-adjustment mechanism to address this possibility.

The plan includes a mechanism for further reductions in the individual income tax rates in subsequent years if, but only if, projected economic expansion (and the resulting government revenue) grow more rapidly than inflation and population. This mechanism will ensure that Kentucky households, and not state government, will reap the lion's share of the benefit of economic expansion.

Modernizing business taxes

The business tax proposal contains four major **components that will stimulate investment** in Kentucky's economy. *JOBS for Kentucky* proposes:

- reducing the top corporation income tax rate
- eliminating the corporation license tax,
- closing certain tax loopholes, and
- adopting a more modern definition of business entities subject to Kentucky tax.

Again, the approach is to lower the rate of taxation and broaden the base, add stability and predictability to the revenue stream, and foster a competitive environment.

Reducing the maximum corporation income tax rate will send the right signal to companies considering investment in Kentucky. Multi-state corporations choose among sites across the fifty states and internationally. A high marginal rate presents a red flag to corporate decision-makers as they narrow their list of potential locations, a signal that this state views business expansion as an opportunity to tax. The new top rate of 6% will place Kentucky in a position of relative strength compared to its competitor states and abroad.

Corporations have long argued that the license tax discourages choices to locate or expand operations in Kentucky. Moreover, they argue that this tax, along with the tax on real and tangible property represents double taxation of the same property. Repealing the license tax, coupled with the repeal of the tax on intangible property, will make Kentucky competitive, particularly in the attraction and retention of capital-intensive industrial companies.

Corporations organized within Kentucky were allowed a deduction against corporate license tax for owned subsidiaries; out-of-state corporations were not afforded this deduction. An out-of-state corporation, Illinois Tool Works, Inc., (ITW) sued, alleging that the deduction was unconstitutional since it favored in-state corporations over those not domiciled within Kentucky. The courts found that the different treatment was unconstitutional, and removed the deduction from all corporate license taxpayers. While the finding was as expected, the means of resolution was unexpected. All parties expected the court to extend the deduction to all corporate taxpayers.

This plan effectively reverses the ITW decision by allowing the deduction for both domestic and foreign companies that hold stock or securities in subsidiaries equal to 50% or more of their total assets. The deduction will be allowed for returns due on or after April 15, 2004.

Currently, businesses pay approximately 43%[4] of all taxes paid in Kentucky. Furthermore, they act as agents in collecting the bulk of personal income and sales taxes. But the distribution of the burden today depends too much on a business's ability to alter its organizational form or to shift income out-of-state and too little on its use of Kentucky services to earn income. The proposal to close loopholes in business taxation will provide for a common method of taxation on businesses with limited liability protection and will result in significant base broadening under the corporation income tax.

Under current law, corporations can form layered structures involving different organizational forms to legally minimize their corporation income tax liability in Kentucky. Such state tax planning has increased in relative importance since 1986, when federal corporate income tax rates dropped significantly. The explosion in the formation of limited liability entities in the past several years attests to the advantages promoted by current tax laws. Kentucky's business tax statutes, regulations, and audit capabilities have not kept pace with the private sector investment in state-level tax planning, creating substantial inequities in the treatment of businesses. While significant amounts of income tax on these forms of business are collected through the individual income tax, disparities exist in the definition of the base and the rates. This proposal maintains the total tax burden on business, but distributes it more evenly and responsibly.

---

[4] *Business Taxation in Kentucky*, David E. Wildasin, Martin School of Public Policy, University of Kentucky, December 1, 2003.

Specifically, the proposal addresses loopholes in the current tax code by:

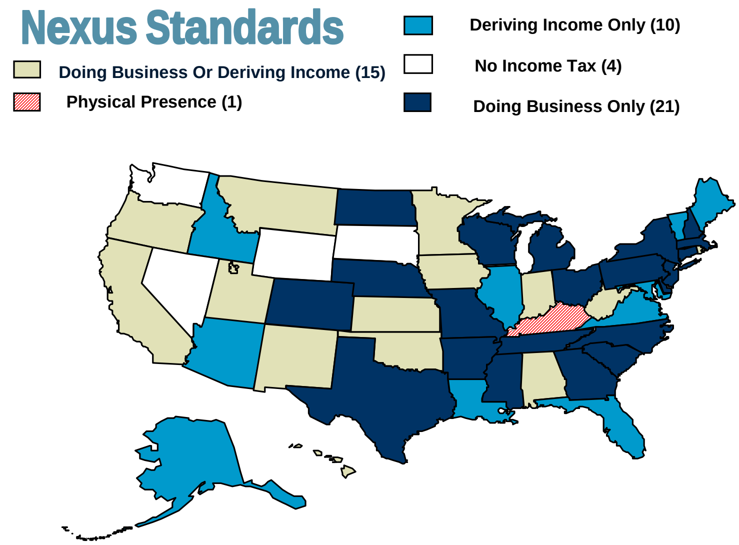
- Requiring nexus consolidated filing for corporation income tax
- Broadening the corporation income tax to include all companies with limited liability and requiring 3-factor apportionment of income
- Requiring 3-factor apportionment for multi-state general partnerships
- Disallowing net operating loss carrybacks
- Requiring an alternative minimum calculation based on Kentucky gross receipts
- Imposing a minimum tax for the privilege of doing business in Kentucky
- Disallowing deductions for payments made between affiliates for expenses related to intellectual property rights (franchise fees, trademark fees, etc.)

Changing the nexus[5] standard in the corporate income tax from one which requires a physical presence in Kentucky to one which only requires doing business here brings Kentucky in line with all of the other states in the U.S., and removes an inequity that disadvantages companies who have made significant commitments in this state. Figure 7 reflects that Kentucky is the only state in the nation that requires a physical presence of business activity to establish nexus for taxation.

In addition, the proposal makes other minor changes to business taxes through provisions that prevent double claiming of the recycling credit.

[5] Nexus refers to the legal tie or link that gives a government the ability to levy a tax on an entity or person.

Figure 7



Even though the business portion of the modernization plan scores virtually revenue neutral in a static sense, the changes have a positive dynamic impact. In particular, the repeal of the corporation license tax is highly stimulative in a dynamic sense because it creates strong incentives for the formation and development of capital investment within the Commonwealth.

Updating property taxes

Intangible property tax

JOBS for Kentucky proposes the **complete elimination of the general intangible property tax**. The tax no longer serves its original purpose, which was to tax property regardless of the form in which it is held. Because of a major court decision in the 1990's, only a few types of intangible assets remain taxable.[6] The remaining tax base includes money market accounts, bonds, loans, notes, mortgage receivables, land contracts, trusts, cash deposits, and accounts receivable. Furthermore, rate reductions on certain types of assets have rendered the tax inequitable and difficult to administer. As such, it raises little revenue and treats property owners differently. This tax has been a source of concern for businesses and households for many years. Approximately 61% of the tax revenues are from the tax on business accounts receivable. The repeal would result in the elimination of approximately 36,000 annual returns and would relieve the Department of Revenue of significant administrative burdens. Most states do not tax intangible personal property.

Real property tax

The proposal recommends revising the annual procedure for setting the state real property tax rate by allowing the state to exclude "new property" from the 4% limit on the increase in revenues from the prior year. Excluding new property will conform the state rate setting process to the existing process for local property tax rate setting.

This proposal will produce a modest revenue increase, slow the decline in the relative contribution of property taxes to the General Fund and will allow property tax receipts in the General Fund to keep better pace with actual growth in the real estate economy. As the tax is based on the stock of real estate rather than yearly income or transaction flows,

[6] The *St. Ledger* case removed stocks and mutual funds from the tax base in 1997. *Herschel St. Ledger, et al., v. Revenue Cabinet, Ky*., 912 S.W.2d 34 (1995), on remand from United States Supreme Court, 924 S.W.2d 893 (Ky. 1997)

it is inherently stable and predictable, as witnessed by the steady growth of assessments over the last decade.

Modernizing sales taxes

Kentucky Enterprise Initiative Act (KEIA)

Outside the current Enterprise Zones, Kentucky currently offers no general sales tax exemption to businesses for building materials. The expiration of the Enterprise Zones and consequent analysis by interested parties has spawned several reform proposals. Because the number of zones was limited to ten, businesses, legislators, and local officials in other areas of the state have shown interest in spreading the benefits of the program. Also, Kentucky offers no sales and use tax exemption for research and development with which to encourage investment in New Economy industries.

Specifically, KEIA offers a new tax incentive program to replace and improve upon the Enterprise Zone (EZ) program that is expiring over the next few years. The program will:

- Extend to eligible companies statewide a refund of sales and use tax on building materials.
- Give preference to companies locating in existing Enterprise Zones.
- Allow a sales and use tax refund for research and development equipment purchases.
- Cap fiscal year commitments to $20 million for building materials and $5 million for R&D equipment.

This proposal targets industries with significant capacity to grow, employ Kentucky residents, and compete in the New Economy. Eligible industries include the manufacturing, service and technology, and tourism sectors, as well as the headquarters or regional offices of companies in any sector.

KEIA allows the existing Enterprise Zones to expire on schedule to fulfill that commitment, but does not extend elements of the EZ program that were problematic, notably the motor vehicle usage tax exemption and the building material exemptions for non-certified companies and residents.

KEIA offers a modest, but important sales tax refund for equipment used in research and development as an incentive to New Economy businesses to locate and stay in Kentucky. These investments bring high-paying professional and technical jobs to Kentucky and foster growth and innovation in regional economies.

Back-to-school sales tax holiday

JOBS for Kentucky creates a 3-day sales tax holiday prior to the beginning of the school year, during which purchases of clothing, school supplies, and computers would be exempt from sales and use tax. Some surveys estimate that the average family spends up to $250 for clothing to get their children ready for school. In addition, technological demands on students throughout their school-age years have placed a greater financial burden on households. And the sales tax on school supplies is regressive, hitting low-income families the hardest. A sales tax holiday is a way to alleviate the tax burden on families as they try to prepare their children for the school year.

Furthermore, it evens the playing field, if only for a short while, for local retailers facing increased competition from Internet transactions where sales and use tax is typically evaded. Kentucky retailers will also benefit from increased cross-border purchases.

Over the last five years, sales tax holidays have proven to be a popular fiscal tool in twelve states. This proposal targets relief at items households typically purchase in August for the new school year and places limits on the dollar value of eligible items to avoid exempting luxury items.

Sales tax nexus

The 1992 Supreme Court decision in *Quill Corp. v. North Dakota* confirmed that states could not force remote sellers to collect tax unless the sellers have a physical presence in the state. To take advantage of this loophole, some traditional retailers (“bricks and mortar” businesses) with a national or regional presence have begun to break out their Internet sales capabilities into separate subsidiaries. For example, a company may have stores in every state, but it does not collect tax on sales it makes over the Internet because it claims that the actual seller is its subsidiary, a “dot-com” company. Products purchased on-line usually can be returned for refund or exchange at the local store. To the consumer, there is no distinction between doing business with the local store or with the dot-com affiliate. This form of tax avoidance creates a disadvantage for local retailers with only a “bricks and mortar” presence.

JOBS for Kentucky proposes to expand the current sales and use tax nexus standard to include remote sellers who use their in-state store location, affiliate or other representative to exploit this tax advantage. While the proposal has a small fiscal impact initially, it is expected to be a growing area of concern if not addressed.

The costs and benefits of current sales tax exemptions

According to the *Tax Expenditure Analysis for Fiscal Years 2004 – 2006* published by the Office of State Budget Director, the current sales and use tax code explicitly exempts over 50 categories of goods, representing over $2.3 billion in potential tax revenue. These exemptions and exclusions have been added in piecemeal fashion since the inception of the tax, but have not been reviewed collectively to assess whether the various exemptions from tax have resulted in a net positive economic impact on the Commonwealth.

The *JOBS for Kentucky* plan calls for the Legislative Research Commission to conduct an in-depth cost/benefit analysis of all statutory exemptions to and exclusions from the sales and use tax law to determine if the exemptions are resulting in a positive impact on the Commonwealth. As many of the exemptions were granted in an economy with very different characteristics than the emerging new economy, a comprehensive review is in order to determine if the proper exemptions are in place to stimulate economic growth.

In addition, *JOBS for Kentucky* proposes codifying the language concerning the jet fuel exemption as well as the extension of sales tax to natural gas transmission and delivery in the most recently enacted budget.[7]

[7] House Bill 269 of the 2003 General Assembly, the Appropriations Act for FY 2002 – 2004.

Increasing tobacco taxes

This modernization plan would impose a surtax, or user fee, of **$0.26 per pack on cigarettes**. In addition to the $0.26 excise tax, the modernization proposal would impose an equity assessment on manufacturers of cigarettes that are not participants in the Master Settlement Agreement (MSA) reached between the states and cigarette manufacturers in 1998.[8] Other tobacco products, which are currently exempt from excise taxation, would be taxed at the wholesale level under the proposal. A ten percent excise tax will be levied on smoking tobacco and cigars. Smokeless tobacco will be subject to an excise tax based on the weight of the product sold, resulting in tax of 9.5 cents per tin of snuff and per pouch of chewing tobacco.

All of the proposed changes are minor compared to the growing trend of taxation of tobacco across the United States, and none of the changes would produce a noticeable impact on tobacco growers or cigarette manufacturers. The commitment of Governor Fletcher to the farming community has not wavered, as witnessed by the preservation of the 50 percent agricultural share of the Phase I tobacco settlement money. Rather, the moderate changes in the taxation of tobacco products underscores an understanding of the importance of the farming community in the Commonwealth, tempered with an understanding that marginal user fees on tobacco products are appropriate and justifiable.

Increasing taxes on tobacco products should have a deterring effect on their use, and therefore result in healthier lifestyles for Kentuckians. The relative taxes on tobacco products in this proposal reflect the growing data from scientific studies that although smokeless tobacco poses some risk, those health risks are significantly less than other forms of tobacco products. It also acknowledges that some in the public health community recognize that tobacco harm reduction should be a complementary strategy to any public health policy towards tobacco products. Taxing tobacco products according to relative risks is a rational tax policy and may well serve the public

[8] The equity assessment would be equal to $0.39 per pack, with credits given to manufacturers for payments in Kentucky MSA escrow accounts net of allocable share cap release refunds.

health goal of reducing smoking-related mortality and morbidity and lowering health care costs associated with tobacco related disease.

Kentucky has the highest incidence of adult smoking in the country. Smoking has partially contributed to large increases in the cost of health care in Kentucky, both in private insurance and the costs associated with Medicaid. Smoking-related diseases include heart disease, asthma, and cancer, all of which place Kentucky in the top 10 worst list among states. (See Figures 8 and 9). Ultimately the tax is voluntary and entirely avoidable for individuals who choose not to consume cigarettes. Studies have also shown that the price increases associated with increasing the excise tax on cigarettes may lower the incidence of youth smoking, a universally desirable outcome. Figure 10 outlines several disturbing statistics related to smoking in Kentucky and the impact it has on the Commonwealth.

Figure 8

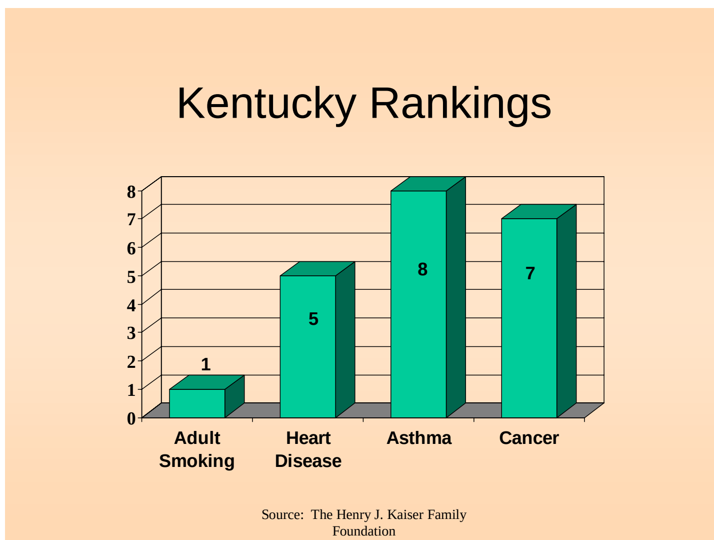
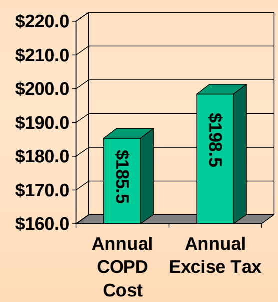


Figure 9

Increased Medicaid Costs

(Chronic Obstructive Pulmonary Diagnostic Cases Only)

- Medicaid costs associated with Chronic Obstructive Pulmonary Diagnostic cases are roughly 6.9% to 7.8% of the Total Medicaid Burden
- The resulting dollar expense is $618.5 million (all funds) and $198.5 million (State share)
- Does not include items such as increased infant morbidity and the myriad of other illnesses indirectly associated with smoking



Kentucky's current excise tax rate on cigarettes is the second-lowest in the country. Only Virginia has a lower state rate at 2.5 cents per pack. With the national average hovering around 73 cents and the average of the surrounding states at over 43 cents per pack, Kentucky's tax rate can be raised substantially without driving its citizens into neighboring jurisdictions. Figure 11 reflects that all states that border Kentucky to the north have significantly higher cigarette taxes than Kentucky. Moreover, many of the neighboring states are also looking to increase excise taxes on cigarettes. The Governor of Virginia, as part of his Budget Bill, proposed an increase to $0.25 per pack at the state level and a $0.50 per pack local option increase. The North Carolina legislature, while not in session until May 10, 2004, has pre-filed proposals to increase the tax up to $0.25 per pack. Finally, the General Assembly in Tennessee is considering two proposals, SB1173 and HB1647, that would increase the state rate to from $0.20 to $0.60 a pack.

Figure 10

The Toll of Tobacco in Kentucky

Tobacco Use in Kentucky

High school students who smoke	**33.0%(76,200) National Average: 28.4%**
Male high school students who use smokeless or spit tobacco	**23.7% (females use much lower)**
Kids (under 18) who become new daily smokers each year	**13,400**
Kids exposed to secondhand smoke at home	**363,000**
Packs of cigarettes bought or smoked by kids each year	**18.3 million**
Adults in Kentucky who smoke	**32.6% (993,300) National Average: 23.3%**

National youth smoking rates have declined somewhat since 1997, but remain at historically high levels. According to the National Youth Tobacco Survey, 28.4% of all U.S. high school kids smoke and 11.6% of high school males use spit tobacco. Adult smoking rates have decreased gradually since the 1980s, and 23.3% of U.S. adults now smoke.

Smoking-Caused Monetary Costs in Kentucky

Annual health care costs in Kentucky directly caused by smoking	**$1.17 billion**
Portion covered by the state Medicaid program	**$380 million**
Residents' state & federal tax burden from smoking-caused government expenditures	**$502 per household**
Smoking-caused productivity losses in Kentucky	**$1.84 billion**

Amounts do not include health costs caused by exposure to secondhand smoke, smoking-caused fires, spit tobacco use, or cigar and pipe smoking. Other non-health costs from tobacco use include residential and commercial property losses from smoking-caused fires (more than $500 million per year nationwide); extra cleaning and maintenance costs made necessary by tobacco smoke and litter (about $4+ billion nationwide for commercial establishments alone); and additional productivity losses from smoking-caused work absences, smoking breaks, and on-the-job performance declines and early termination of employment caused by smoking-caused disability or illness (dollar amount listed above is just from productive work lives shortened by smoking-caused death).

Sources: National Youth Tobacco Survey (Estimates on Youth Smoking), Center for Disease Control (Estimates for Adult Smoking), Campaign for Tobacco Free Kids (Estimates of State Medicaid Costs).

Figure 11

Economics of Higher Cigarette Taxes

Border with Kentucky	Kentucky Population	Other State Population
Indiana (55.5¢)	1,135,860	595,521
Ohio (55.5¢)	330,532	1,234,409
Illinois (98¢)	108,625	47,757
Missouri (55.5¢)	10,613	86,389
Tennessee (20¢)	368,033	561,416
West Virginia 55¢	127,215	98,485
Virginia (2.5¢)	107,085	77,889

Like most consumption taxes, the burden of this tax falls on those who choose to buy the product. Smoking saps the vitality of users and the resources of the medical community. Because of the increased cost to all Kentuckians it is fair and appropriate to require that a greater portion of this burden be borne by those who freely chose to use these products. It is likely that some will choose to stop using tobacco products as the result of this added burden and that will be good in the long run for them personally and for Kentucky's health as well.

The proposal also imposes an inventory or floor tax. An inventory tax would require any seller of cigarettes to file a return that included an inventory of all un-affixed Kentucky excise tax stamps and Kentucky-stamped cigarettes in its 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 wholesalers hoarding packs stamped at the lower rate.

Simplifying/ raising alcohol taxes

A proposal to **simplify the taxes Kentucky levies on alcoholic beverages** is long overdue. There are currently three taxes on distilled spirits, two taxes on beer, and two on wine. Seventy-eight percent of alcoholic beverage tax dollars are generated through a wholesale sales tax. The remaining 22% is raised through excise taxes levied on various volume measures of distilled spirits, beer, and wine and the distilled spirits case sales tax. By repealing both the excise tax on distilled spirits, wine and beer, as well as the distilled spirits case sales tax, and increasing the wholesale sales tax, Kentucky can remove the administrative burden on taxpayers as well as the Commonwealth.

In keeping with a desire to minimize the impact of taxes on consumption choices, this proposed increase in tax rates will increase taxes on these items but will not alter the current relative tax burden on distilled sprits, wine, and beer. Thus each will have its own wholesale sales tax rate.

Creating a simplified statewide communications services tax

The current **taxation of telecommunications services** is based on a tax structure developed in the late 19th century. The tax laws assumed that the providers of these services were regulated monopolies, and that all forms of communication would be provided over hardwired point-to-point communications. Telecommunications companies, notably telegraph and telephone, were granted a franchise or privilege by local governments and were taxed on this basis.

Over a hundred years later, in 1996, the Federal Communications Commission (FCC) deregulated most of the aspects of rate regulation for telecommunications services. The deregulation was a result of the rapid changes in communications introduced by new technology. Deregulation also removed barriers to competition and thereby reduced the value of a protected franchise in providing services like multi-channel programming and long-distance phone. The rapid evolution of technology continues today. Cable television, Internet, wireless or cellular telephones, broadband, and satellite services are now available to most consumers and are provided in a competitive environment. The same phone service provided by a regulated wire line phone company is also available from cable, wireless phones, or through the Internet. As the new technologies have converged to be in direct competition with each other, problems regarding the nature of the present tax system have emerged. The time has come to modernize a 19th century tax structure for the 21st century reality.

Communications Excise Tax

JOBS for Kentucky proposes a single excise tax on communications services at the end-user level. The tax is only on the service, whether it is telephone or multi-channel programming, and is independent of the delivery method. This method of taxation not only addresses the current needs of the industry and consumers, but also allows for changes taking place in the communications services industry. Methods of service delivery will continue to change rapidly. Placing the tax on the end product ensures that the tax structure is independent of the how the services are delivered.

The communications excise tax also addresses the disparity of the tax base between cable and direct broadcast satellite (DBS). This problem was recently highlighted by a court decision[9] that held that the franchise value of both cable and DBS should be taxed similarly. Under Kentucky's current tax structure, DBS is not subject to taxation.

The communications excise tax will replace:

- The 6% sales tax levied by the state on all telephone services including the standard monthly charge, intrastate and long-distance calls.
- The local franchise fee on telephone and cable companies. It is currently levied by counties and cities on those telephone and cable companies awarded a local franchise. The rates range from 0% to 5.67%.
- The public service company property tax (also called the franchise value tax) levied on telephone and cable companies. The tax is assessed by the state and collected by state and local authorities.

The communications excise tax will:

- Eliminate sales tax on switch access charges and other telecommunications services for resale.
- Guarantee local governments a fixed amount to replace the PSC property tax and franchise fees, and provide a percentage share in any growth to the communications excise tax base.
- Tax all end-users of telecommunications services on the same basis.

The replacement of three taxes (sales, franchise fee, and franchise value) with a single tax results in simplification and brings equity to the taxation of like services. The communications excise tax simplifies the billing of local taxes to businesses by replacing tax returns from over a thousand local taxing

[9] *Insight Kentucky Partners II, L.P. v. Revenue Cabinet*, KY TAX REPORTER CCH) ¶202-722 (Franklin Cir. Ct., Division II, Civil Action No. 01-CI-01528, February 5, 2004 opinion and order)

jurisdictions with a single return from the Department of Revenue. Moreover, instituting a single communications excise tax addresses the recent court decision that finds the levying of a tax on cable, but not on its satellite competitor, to be unconstitutional. The new tax will provide a reliable revenue base by replacing the eroding PSC property tax on telephone and cable companies, which is constantly being challenged on its assessed value.

Tourism, meeting and convention development

JOBS for Kentucky **proposes a 1% lodging tax** on all hotel and motel receipts and dedication of the funds to marketing the state. Research conducted by the Department of Travel in the Kentucky Commerce Cabinet concluded that every dollar spent on advertising promotion has resulted in a $30 dollar return on investment. The proceeds from the tax would be used to:

- Boost Kentucky's presence in the meetings, conventions and group travel market.
- Dramatically increase money available to the nine Kentucky tourism regions in the form of matching funds.
- Conduct expanded research that assists the state in determining likely visitor profile; effectiveness of advertising and marketing efforts and the potential for new product development, such as Kentucky golfing trails.
- Grow consumer awareness of Kentucky as a travel destination through integrated advertising and marketing programs, with a special emphasis on the Internet. The Internet is the largest source of travel information now in use and continues to grow. In recent focus group research many respondents cited lack of knowledge about Kentucky as the main reason they have not visited before.
- Take advantage of tourism trends in niche markets through special promotion and development programs.

The additional funding for tourism promotion will allow the state to more readily compete for potential travelers. Kentucky currently ranks 31st in the country in both overall budget of the tourism office and advertising dollars spent to promote tourism. This new funding source would raise Kentucky's ranking to somewhere between 8th and 14th in the nation.

Impact on taxpayers

JOBS for Kentucky **proposals have been shown to be revenue neutral** in the aggregate, but how will Kentucky households and individuals be affected? To find out, ten representative taxpayer profiles were developed and the tax liability of each group under current tax law was compared to their tax liability under the proposed tax changes. The profiles contain single and married taxpayers with a wide range of incomes, both earned and retirement income, as well as with and without dependents. The ten profiles account for approximately 320,000 of the Commonwealth's nearly 1.6 million households.

The ten taxpayer profiles are presented in Figure 12 with a discussion of the how these representative families fare in the first year of implementation of the Fletcher tax modernization proposals.

Figure 12

Taxpayer Status	Federal Adjusted Gross Income	Family Size	No. of Households
Single	$20,000	No Dependents	117,500
Single	$25,000	Two Dependents	21,000
Single	$50,000	Two Dependents	5,700
Single	$50,000	No Dependents	18,300
Single	$100,00	No Dependents	2,225
Married	$30,000	Two Dependents	21,600
Married	$40,000	No Dependents	34,000
Married	$70,000	No Dependents	65,200
Married	$75,000	Two Dependents	20,325
Retired	$40,000 Retirement	No Dependents	13,832

Nonsmokers fare better than smokers in all taxpayer profiles because for smokers, it is assumed that they smoke one pack of cigarettes a day and, therefore, will face an annual tax increase of $146. Similarly, drinkers will realize a tax increase and be worse off than nondrinkers. Those who consume an average of $10 per week in alcoholic beverages will see an annual tax increase of $23.

Nonsmokers who also abstain from alcohol, nine of the 10 taxpayers profiled, realize a tax reduction under the proposed tax plan, primarily because of the individual income tax whose effects are large relative to the other components of the tax plan. Generally, those benefiting most under the plan are low-income taxpayers with dependents and single, high-income taxpayers who benefit from a reduction in the top marginal tax rate.

At the other end of the spectrum, wealthier retirees may face a minimal negative impact because their income (in the example) is already exempt from state taxation so they receive no benefit from the rate reduction.

The property tax proposals, adjusting the state real property tax rate and repealing the intangible property tax produce minimal tax consequences for Kentuckians in the profiles.

Based on the assumption that higher income persons spend more on communications services, higher income taxpayers will pay more than low-income taxpayers under the communications tax proposal. The tax increases range from $21 to $45 per year depending on the types and amount of services consumed.

Details for each of the ten taxpayer profiles can be found in Figures 13 and 14.

Figure 13

Tax Profiles: Single Taxpayers

	Single Person No Dependents $20,000*	Single Parent Two Dependents $25,000*	Single Parent Two Dependents $50,000*	Single Person No Dependents $50,000*	Single Person No Dependents $100,000*
Current Tax Liability (Nonsmoker)	***$820***	***$1,154***	***$2,657***	***$2,700***	***$5,526***
Current Tax Liability (Pack-A-Day Smoker)	***$831***	***$1,165***	***$2,668***	***$2,711***	***$5,537***
Tax Modernization Proposals (Liability Change)					
Individual Income Tax	-$28	-$46	-$118	-$118	-$263
Exclude New Property From State Property Tax Rate	$0	$0	$2	$2	$3

Figure 14

Tax Profiles: Married Taxpayers

	Married Couple Two Dependents $30,000*	Married Couple No Dependents $40,000*	Married Couple No Dependents $40,000 Retirement	Married Couple No Dependents $70,000*	Married Couple Two Dependents $75,000*
Current Tax Liability (Nonsmoker)	***$1,245***	***$1,883***	***$270***	***$3,613***	***$3,876***
Current Tax Liability (Pack-A-Day Smoker)	***$1,256***	***$1,894***	***$281***	***$3,624***	***$3,887***
Tax Modernization Proposals (Liability Change)					
Individual Income Tax	-$33	-$64	$0	-$150	-$165
Exclude New Property From State Property Tax Rate	$1	$1	$2	$2	$2
Repeal Intangible Property Tax	-$2	-$2	-$3	-$3	-$3
Increase Cigarette Tax to $0.29	$95	$95	$95	$95	$95
Simplify Taxes on Alcohol Products	$11	$11	$11	$11	$11
Communications Services	$21	$21	$35	$36	$45
Tax Liability Change (Smoker, Drinker)	***$94***	***$62***	***$141***	***-$8***	***-$14***
Tax Liability Change (Nonsmoker, Drinker)	***-$1***	***-$33***	***$46***	***-$103***	***-$109***
Tax Liability Change (Smoker, Nondrinker)	***$83***	***$51***	***$129***	***-$20***	***-$26***
Tax Liability Change (Nonsmoker, Nondrinker)	***-$13***	***-$44***	***$34***	***-$115***	***-$121***

*Federally adjusted gross income

A call to action

In ***JOBS for Kentucky***, the Fletcher administration has outlined the recent history of the tax modernization debate, and rests many of its conclusions on the work of scholars and public officials that were party to this debate. The plan further emphasizes the philosophy that is at least implicit in many of the assertions of past tax studies, that wherever possible, taxes ought not to interfere with the decisions of households and business. This interference is directly proportional to the marginal tax rates imposed on choices to earn income, invest, and locate in Kentucky. Economists defend, and the regional impact models verify, the wisdom of efficient taxation.

Regrettably, Kentucky's tax code is so rife with inconsistencies and inequities that it has become impossible to defend in the courts and in the public eye. Largely a product of historical context, today's laws fail to embrace and embody the present economic and demographic realities. They serve masters that no longer exist or are fading from the economic stage as the world moves on with an economy that is faster, more productive, more mobile, and more diverse. A piecemeal approach to tax policy generally results in more inequity and inconsistency, and signals a desire for the status quo. Policy-makers witness today the obstacles past choices have set before their constituents. Families struggle to meet expenses, factories close and jobs leave for the smallest of incremental advantage, and public officials strain to plan under the uncertainty of a unpredictable, unstable source of revenue.

This proposal combines the wisdom gleaned from years of study and experience with the realities of the market economy to ensure Kentucky will grow and that its people will prosper. This prosperity needs no partnership with government, but only the assurance that government will not get in the way of the innovative capacity of the citizens of Kentucky. Only then can government planners be confident that the productive resources of the state will support the demand for public services.

The economy has already shown its ability to outpace legislative action. The Fletcher Administration proposes that the time has come for comprehensive change.

APPENDIX A

HOW DOES THE PROPOSAL STACK UP TO PRIOR RECOMMENDATIONS?

Prior studies

Since 1995 several studies have been commissioned to examine the state's tax structure: These studies, undertaken at different times, have focused on the same recurring themes in regard to Kentucky's tax structure: Fairness, competitiveness, simplicity, and adequacy. Despite the conclusions that Kentucky's tax structure contains numerous shortcomings, in each of these categories, the state has not addressed the issue of fundamental tax reform in recent years.

In 1995 Governor Brereton Jones created the Kentucky Commission on Tax Policy, which issued its report in November of that year. Their major recommendations included:

- *Individual Income Tax:* Adopt the federal adjusted gross income, filing status, standard deduction, and personal exemptions as the starting point for calculating Kentucky individual income taxes, eliminate low income tax credits, and adopt a flat 6 % rate.

- *Corporate Taxes:* Lower the top corporation income tax rate to 7%, restrict corporate filing options (consolidated vs. separate entity filing), eliminate net operating loss carryback provisions, extend tax to financial institutions and public service companies (PSC), and make adjustments to corporate license tax.

- *Property Taxes:* Remove Kentucky's intangible property tax, modify provisions of House Bill 44, eliminate tangible property tax with an offsetting rate to real property tax, provide relief to low-income property owners, and eliminate the un-mined minerals property tax.

- *Sales and Use Tax:* Extend the sales tax to selected services.

- *Miscellaneous Taxes:* Remove health care provider tax on physician's services only, eliminate inheritance tax, and reduce pari-mutuel taxes.

In 2002, the Kentucky legislature hired Dr. William F. Fox of the University of Tennessee to analyze Kentucky's tax structure and make recommendations. Dr. Fox's major recommendations included:

- *Sales and Use Tax:* Impose sales tax requirement on Internet affiliates of Kentucky retailers. Extend sales tax to selected services.

- *Business Taxes:* Require corporate filers to file combined tax returns. Tax LLCs like corporations. Allow Enterprise Zones to expire. Broaden the definition of corporate nexus to include a "doing business" standard.

- *Property Taxes:* Allow state property tax rate calculation to exclude newly constructed property prior to imposition of 4% limit required by House Bill 44, or freeze the real property tax rate at its current level. Eliminate the property tax on motor vehicles.

- *Individual Income Tax:* Eliminate deductions for income taxes paid to foreign companies.

- *Telecommunications Taxes:* Replace current ad valorem taxes on telecommunications with a single revenue-neutral tax.

- *Miscellaneous Taxes:* Raise the cigarette tax, and place tax on other tobacco products, raise the excise tax on alcohol, and eliminate the motor vehicle usage tax on large trucks.

Several recommendations from the 1995 Tax Commission study have been adopted. Among these are:

- Limit corporation election of filing status (separate or combined) to one change every eight years. (1996)
- Removal of the health care provider tax on physician services. This was phased out between 1996 and 1999.
- Apply corporate income tax to financial institutions and PSCs. This recommendation was not adopted, but subsequent to the commission's recommendations, in 1996 the bank shares property tax that this proposal addressed was replaced with the bank franchise tax.
- Equal treatment of in-state and out-of-state holding companies for corporation license tax. This was decided in litigation, rather than in legislation, by the ITW decision in early 2003.
- Eliminate the intangible property tax. Most of this tax was removed as a result of the St. Ledger decision in 1997.
- Eliminate tangible personal property tax with offsetting revenue-neutral change in the real property rate. This was not adopted, although the mechanism for doing so was created constitutionally in 1998 when voters approved an amendment allowing the General Assembly to exempt tangible property from taxation.

One piece of significant tax legislation was enacted by the 2000 General Assembly when it extended sales tax treatment to interstate long-distance telephone calls. Also, the 2000 General Assembly declined to remove the sales tax on switch access fees, which are access charges purchased by telecommunications companies from each other. These are not eligible for exemption under the “sale for resale” classification since that refers to sales of tangible goods only.

Legislation based on recommendations in the Fox study was enacted in 2003:

- Allowed Enterprise Zones to expire based on their original expiration dates. Two such Enterprise Zones expired on December 31, 2003: Hickman and Louisville.
- Eliminated the deduction for foreign income taxes. This was accomplished through the budget bill in 2003 rather than by statute, and will expire on June 30, 2004.
- Eliminated the motor vehicle usage tax on large trucks.

JOBS for Kentucky

The *JOBS for Kentucky* tax modernization plan addresses many of the recommendations made by the 1995 Kentucky Tax Policy Commission and the Fox Report. Among the recommendations made by the Tax Policy Commission that are included are to lower the top corporate income tax rate, restrict filing options (consolidated vs. separate filing), and limit the net operating loss of corporations to be carried forward only. The Commission also recommended altering the structure of the corporate license tax, which is being done by eliminating the tax. The Fox report contained the recommendation to tax LLCs like corporations and to broaden corporate nexus to a “doing business” standard, both of which are included in the Fletcher tax modernization proposal.

Both studies recommended alterations to House Bill 44 to arrest the continuous slide in real property tax rates. The Commission Study also called for removing the intangible property tax. These are both components of the Fletcher plan. The plan also achieves several other objectives recommended in the Fox report: imposing sales tax collection requirements on internet affiliates of retailers with Kentucky presence, raising both the cigarette and alcohol excise taxes, and reforming telecommunications taxes.

Figures 15 and 16 compare the specific recommendations made by the prior studies to the Fletcher recommended plan for modernizing Kentucky’s tax code.

Figure 15

1995 Tax Policy Commission Recommendations

	Previously Adopted	Included in JOBS for Kentucky
Individual Income Tax		
Adopt the federal adjusted gross income, filing status, standard deduction, and personal exemptions as the starting point for calculating Kentucky individual income taxes.	**NO**	**NO**
Eliminate low income tax credits.	**NO**	**NO**
Adopt a flat 6 percent rate.	**NO**	**NO**
Corporate Taxes		
Lower the top corporation income tax rate to 7 percent.	**NO**	**YES**[1]
Restrict corporate filing options (consolidated vs. separate entity filing).	**NO**	**YES**
Eliminate net operating loss carryback provisions.	**NO**	**YES**
Extend tax to financial institutions and public service companies.	**YES**[2]	**N/A**
Adjustments to corporation license tax.	**NO**	**YES**[3]
Property Taxes		
Remove Kentucky's intangible property tax.	**NO**	**YES**
Modify provisions of House Bill 44.	**NO**	**YES**
Eliminate tangible property tax with offsetting rate to real property tax.	**NO**	**NO**
Provide relief to low income property owners.	**NO**	**NO**
Eliminate the unmined minerals property tax.	**NO**	**NO**
Sales Taxes		
Extend the sales tax to selected services.	**NO**	**NO**
Miscellaneous		
Remove health care provider tax on physicians services only.	**YES**	**N/A**
Eliminate remaining inheritance tax, retain estate tax.	**NO**	**NO**
Reduce pari-mutuel tax.	**NO**	**NO**

Notes:

1. This proposal exceeds this by lowering the rate to 6 percent.
2. A separate bank franchise tax was enacted in 1996 to solve the problem the proposal was addressing.
3. Corporation license tax will be eliminated under JOBS for Kentucky.

Figure 16

Fox Report Recommendations

	Previously Adopted	Included in JOBS for Kentucky
Individual Income Tax		
Eliminate deduction for income taxes paid to foreign countries.	**NO**[1]	**YES**
Corporate Taxes		
Require corporate filers to file combined tax returns.	**NO**	**NO**
Tax LLCs like corporations.	**NO**	**YES**
Allow Enterprise Zones to expire.	**YES**	**NO**[2]
Redefine nexus to "doing business" standard.	**NO**	**YES**
Property Taxes		
Allow state property tax rate calculation to exclude newly constructed property prior to imposition of four-percent limit required by House Bill 44, or freeze real property tax rate at its current level.	**NO**	**YES**
Eliminate the property tax on motor vehicles.	**NO**	**NO**
Sales Taxes		
Impose sales tax requirement on internet affiliates of Kentucky retailers.	**NO**	**YES**
Extend sales tax to selected services.	**NO**	**NO**
Telecommunications Taxes		
Replace existing ad valorem state and local taxes on telecommunications services with single revenue neutral tax.	**NO**	**YES**[3]
Miscellaneous Taxes		
Raise the cigarette tax, and place tax on other tobacco products.	**NO**	**YES**
Raise the excise tax on alcohol.	**NO**	**YES**
Eliminate the motor vehicle usage tax on large trucks.	**YES**	**N/A**

Notes:

1. This measure was included as a part of the enacted FY03-04 budget, but has not been codified permanently.
2. Enterprise Zones are replaced in this proposal by an *Enterprise Initiative* that provides statewide incentives with increased accountability and preference given to existing Enterprise Zone geographic areas.
3. The proposed rate of 7.62% on the communications excise tax is not revenue neutral.

APPENDIX B

REDUCING INDIVIDUAL INCOME TAXES

Proposal

Update Kentucky's individual income tax to provide relief to low-income Kentuckians, attract and retain human capital in the state by lowering the top marginal income tax rate and make technical adjustments to modernize the tax code.

Overview of the proposal

- Provide relief to low-income persons, expand the Low Income Credit.
- Provide relief to all who pay tax, lower the top tax rate to 5.68%.
- Reaffirm a commitment to the agricultural community, provide a further exemption of future tobacco quota buyout or buy-down payments.
- Establish a set pension exclusion allowed annually for each pensioner.
- Remove the deduction for foreign income tax paid.
- Provide individual owners of certain pass-through entities with a credit for the tax paid by the entity. Clarify that banks that are pass-through entities are also taxed only once.
- Revise the recycling credit to recapture the credit if the property is re-sold.
- Modernize the administration and filing of income tax returns by:
    - Allowing general partnerships to file composite returns for non-resident partners,
    - Clarifying the order various credits should be claimed,
    - Allowing a 'perjury' declaration to be electronically signed,
    - Provide for the annual electronic publishing of withholding tables.

Detail of the components of the proposal

Low income relief

Proposal: Increase the lowest bracket of the Low Income Credit to exclude from tax a person whose income is at or below $12,000, and adjust other brackets for this change, and clarify who is eligible for the credit. By using modified federal Adjusted Gross Income as the qualifier for application of the credit, persons who have low incomes will qualify, while persons with higher incomes that are not taxed to Kentucky will not.

Background: Kentucky's current Low Income Credit excludes from tax a person whose income is at or below $5,000. Remaining brackets reduce income tax for incomes below $25,000.

Rationale for the Proposal: The proposed adjustments to the Low Income Credit will give significant relief to lower income Kentuckians. A single taxpayer whose income is $12,000 would currently owe as much as $388 in tax. This proposal would reduce that person's income tax liability to zero. A single person whose income is at the federal poverty level would owe no income tax. A family of two at the federal poverty level would save up to $130, while larger families would save smaller amounts. Current qualifications for the low income credit are ambiguous; persons with significant income taxed by the federal government may be able to qualify as low-income persons in Kentucky, and take advantage of the low-income credit even though they have high levels of income.

Lower the top tax rate

Proposal: Lower the top rate of tax to 5.68%.

Background: Current rate brackets are from 2% to 6% of taxable income, with the 6% rate applied to all income over $8,000.

Rationale for the Proposal: Kentucky's tax rates have not changed in over 40 years. When first established, few taxpayers had incomes that reached the level of the highest tax bracket ($8,000). Kentucky's income tax has essentially become a flat tax, with almost all income taxed at 6% for most taxpayers. By reducing the top rate to 5.68%, virtually all filers who owe tax will receive a reduction in liability.

Exempt future tobacco quota buyout or buy-down payments

Proposal: Exclude from income tax any income received as the result of a federal tobacco buyout/buy-down program.

Background: Kentucky has a history of excluding from income tax any special income related to tobacco farming.

Rationale for the Proposal: By excluding from income tax any payments related to the restriction or removal of quotas in tobacco farming, this plan reaffirms a strong commitment to Kentucky's agricultural heritage. Excluding this income provides assistance to the agricultural community and continues to foster efforts to find alternative crops and reduce the dependence of farmers on a dwindling income source.

Establish a set pension exclusion amount

Proposal: The pension exclusion would be set at the current amount of $40,200 annually per taxpayer. The pension exclusion would no longer be indexed.

Background: The pension exclusion became effective in 1995 with an excluded amount of $35,000. It has grown based on CPI to the 2004 exclusion of $40,200.

In recent years both legislative and judicial action have expanded the amount of the exclusion and the number of pensioners who may exclude income.

Rationale for the Proposal: The pension exclusion has been increasing steadily for the last several years, it is estimated that more than 98% of pensioners exclude all of their pension income from Kentucky tax. These pensioners represent more than 95% of pension income received. This plan would maintain the pension exclusion at current levels; it would not increase or decrease in future years. Several court decisions over the last decade have clarified that pension income must be treated equally if from similar sources, but have not required exclusion or taxation. In recent years the legislature has chosen to exempt progressively more pension income. With the aging of Kentucky's population, pension exclusions have become more significant, and more expensive. By capping the exclusion at this level, the future income tax base will be broadened. As pensioners become a larger part of the population, it becomes more necessary to tax part of pension income if the integrity of the income tax system is to be protected.

Remove the deduction for foreign income tax paid

Proposal: Remove the deduction for foreign income tax paid, in a manner similar to the disallowance of the federal income tax deduction in 1990.

Background: The foreign income tax deduction has been removed in the enacted budget for FY 2002 - 2004; this provision would make permanent an exclusion that is already considered removed in the consensus revenue estimates.

Rationale for the Proposal: The foreign income tax deduction should have been removed when the federal tax deduction was removed in 1990. It was originally allowed as a complement to the federal tax deduction. To continue to allow a deduction for foreign income tax paid while not allowing a deduction for U.S. federal income tax paid is inconsistent and not conducive to domestic investment.

Credit allowed for tax paid by certain owned business entities

Proposal: Individual owners of pass-through entities will continue to be taxed on the business income, but will also receive a passed-through credit of their proportionate amount of tax paid by the entity. The credit will be limited to the amount of tax that the individual would have owed on the same income.

Background: Individual owners of pass-through entities currently are taxed on that income, but the entity currently pays no tax on that income.

Rationale for the Proposal: Pass-through entities will now pay a new entity-level tax, but the income is also taxable to the individual owner. This proposal allows a credit to the individual for the proportionate share of that entity level tax, with the credit limited to the amount of tax the individual would have paid on the income that is passed through to the individual. To assure equal treatment of banks that are owned as pass-through entities, the treatment of their income will be modified slightly. Individual owners of banks that have elected to be treated as "S" corporations are exempted from paying income tax on the passed-through share of bank income, since the bank must pay an entity level tax assessed by the state. When this exclusion was put into law, banks were required to be located in Kentucky, and the tax was required to be assessed. Now, banks can be multi-state, and the bank franchise tax might not have been paid. This change allows the exclusion if the Kentucky bank franchise tax has been paid.

Revision to the recycling credit

Proposal: Revise the recycling credit to recapture the credit if the property is resold, and provide a definition for secondary waste.

Background: Property that is subject to the recycling credit may currently be resold without any recapture or loss of the credit to the original purchaser. Each subsequent purchaser may also claim the credit.

Rationale for the Proposal: Kentucky's recycling credit may be claimed by multiple purchasers of the same item, with no regard for how long each purchaser holds or owns the item. The intent of the recycling credit is to encourage conservation and recycling; recapturing part of the credit if a purchaser disposes of an item prematurely assures that valid credits are allowed while protecting the system from abuse. Providing a definition for secondary waste gives guidance to taxpayers who are determining what is eligible.

Modernize the administration and filing of income tax returns

Proposal:

- Allow general partnerships to file a composite return for electing nonresident individual partners and pay the tax computed at the top marginal rate.
- Clarify the order for claiming the various credits available to individuals.
- Remove the requirement that the perjury declaration that must be executed for each tax return be written.
- Provide for the annual electronic publishing of current withholding tables.

Background:

- Non-resident partners of general partnerships must file an individual income tax return with Kentucky, even if the income from the partnership is their only Kentucky income.
- The statutes are imprecise as to the order for claiming credits, occasionally causing confusion on the part of filers.
- For each tax return filed, a statement of correctness must be signed under the penalty of perjury.
- There is no standardized timing requirement for publishing or updating withholding tables. They are published in book form as needed, when changes warrant an update.

Rationale for the Proposal:

- Many partnerships have partners that are not Kentucky residents, and the income from the partnership is the only Kentucky-source income for the partners. Allowing a single 'composite' return to be filed by the partnership for all such filers is much easier on the partners and on the state of Kentucky, and encourages compliance by out of state filers.
- Clarifying the order for claiming credits makes filing easier for filers who have multiple credits to claim. The new language of this statute will correspond with the way credits are currently allowed by the Department of Revenue.
- With the advent of electronic filings and signatures, many items that used to require a manual signature are now legal and binding with an 'electronic' signature. This change permits electronic tax return filers to affirm the correctness of their tax return with an electronic signature.
- Electronic publishing of withholding tables assures businesses that the most recent tables are available, and removes the requirement that the tables be printed and distributed in book form. The vast majority of businesses access withholding information electronically, and use formulas rather than printed tables in determining amounts to withhold.

Fiscal impact

The net effect of this proposal is to lower expected Kentucky individual income tax receipts by approximately $160 million annually.

Impact on taxpayers

Based on the above changes, it is estimated that approximately 125,000 low-income filers representing 300,000 Kentuckians would be removed from the tax rolls. Approximately 250,000 additional lower income filers will see significant decreases in tax liability. Almost all filers not removed from the tax rolls will benefit from a reduced rate of tax. The highest tax rate will fall from 6% of taxable income to 5.68% of taxable income.

While changes in taxing systems and methods of calculation will impact different taxpayer groups in different ways, it is difficult to identify any category or group of taxpayers (other than those with income not taxed by Kentucky) whose income tax liability is negatively impacted by this proposal.

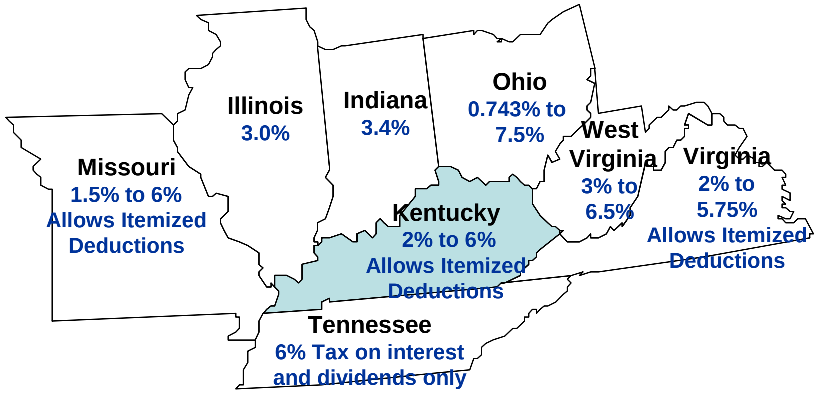
The qualifications for the low income credit are clarified and 'tightened' in this plan. Taxpayers who are truly low income will receive significant benefits, with many being removed from the tax rolls. Under current tax law, however, certain taxpayers with significant amounts of income not taxed by Kentucky have been able to claim the low income credit. Those taxpayers who have income that is taxed by the federal government but not taxed by Kentucky will be required to consider this other income in determining eligibility for the credit. For some of these higher income taxpayers, this plan would no longer allow them the benefit of the low-income credit. This change narrows the target of the credit, to assure that higher-income individuals do not inadvertently receive a tax benefit intended for low-income taxpayers. Under the new plan, this person would pay the new lower tax rate on the Kentucky taxable income, but would not benefit from the low-income credit.

Impact on competitiveness compared to other states

By lowering the top income tax rate, Kentucky moves below several surrounding states when top rates are compared. Kentucky's top rate would move lower than Virginia, Missouri, Ohio, and West Virginia.

Kentucky's current income tax rates are not conducive to the attraction of human capital and higher paying jobs. With a reduction in the top tax rate, Kentucky will become more competitive in this arena. The attraction of higher paying jobs provides an additional source of entry level and support positions, which are more often filled by persons currently living in the area. This could be a significant source of job opportunities for current residents of this state.

Current Individual Income Tax Rates for Contiguous States



Source: Commerce Clearing House, Inc.

ADDITIONAL TAX CUTS

Proposal

Provide a mechanism to require future reductions in individual income tax rates if and when projected biennial revenues exceed current year appropriations plus growth factors for inflation and population growth. Half of any projected excess revenues beyond the "trigger" amount would be dedicated to reducing all marginal rates in increments of .05%.

Rationale

The Governor insisted that any plan of tax modernization satisfy two requirements:

- First, that it be revenue-neutral and fulfill his pledge of no new taxes on Kentuckians.
- Second, that any overhaul of Kentucky's tax code would stimulate the Kentucky economy, attract and retain human capital and promote an investment-friendly environment.

This plan fully satisfies those requirements. In the next biennium, the plan generates no additional revenue for state government—no new revenue, that is, unless and until the plan achieves its objective of stimulating the private sector and growing Kentucky's economy. When the plan is examined using a "dynamic scoring" model, it is possible to project the success of the plan's "stimulative" nature.

Because the plan removes obstacles to expansion and growth, the dynamic scoring model forecasts growth in the overall tax base in the out years. By lowering the top rate from 6% to 5.68%, as well as the promise of future reductions, this plan will make Kentucky more competitive.

Indeed, it is possible that the plan will be even more effective in stimulating jobs growth and economic activity than is now predicted. In order to be faithful to the principle of fiscal responsibility and the no-new-tax pledge, the plan contains a revenue-adjustment mechanism to address this possibility.

LOCAL TAX STUDY TASK FORCE

Proposal

JOBS for Kentucky calls for the creation of a task force with representation from the executive branch, the legislative branch, local governments, and independent businesses to study the methods of taxation utilized by local governments. The group will be directed to develop a proposal for the modernization of local taxation, with the stated goal to further remove impediments to the creation and formation of human capital, capital investment, and job creation within the Commonwealth.

Function of the task force

- Evaluate the current structure of local taxation utilized by Kentucky's localities.
- Determine the total local tax burden in various Kentucky localities.
- Determine the total revenues generated by local income and occupational taxes, restaurant and lodging taxes, and all other local taxes.
- Determine other methods for generating the same amount of local revenue.
- Evaluate and recommend alternate methods, including local sales taxes.

Rationale for proposal

Local taxation in Kentucky has been inconsistent and sporadic relative to both rates and application of taxes. Most municipalities impose a local income tax (usually called an occupational tax). Many counties also impose a similar tax. Many local governments also impose restaurant and lodging taxes.

Several of the tax studies that have taken place over the past ten years have attempted to include local taxation in their charge, but only relating to a change in rate for the current tax structure. None has directly examined the prospect of changing the style or type of taxation.

Local taxes can have a marked effect upon the appearance of tax competitiveness, especially when coupled with the impact of state taxes. For example, if local income taxes were replaced with a local sales tax, and if the top state rate declined to 5.68%, the net effect for income taxes would be a decline from more than 8.5% to a new rate of 5.68%. This level of rate change would be extremely attractive to businesses and individuals interested in relocating to Kentucky.

MODERNIZING BUSINESS TAXES

Proposal

- Repeal the corporation license tax.

- Expand the corporation income tax to apply to all business entities with limited liability protection and apply an alternative minimum calculation (AMC) based on Kentucky gross receipts. The tax due will be the greater of:
  - A graduated 4% to 6% tax on net income; or
  - 9.5 cents per $100 (.00095) of Kentucky gross receipts (AMC); or
  - A minimum tax due of $250

- The rate brackets for calculating the tax on net income will be:
  - 4% of the first $50,000 of taxable net income
  - 5% of the next $50,000 of taxable net income
  - 6% of the taxable net income in excess of $100,000

- The tax base of the AMC includes the following:

  - Gross receipts from the sale of real property located in Kentucky;
  - Gross receipts, less returns and allowances, from the sale of tangible personal property located in Kentucky that is shipped or delivered to a purchaser in Kentucky regardless of the f.o.b. point or other conditions of sale;
  - Gross receipts, less returns and allowances, from the sale of tangible personal property shipped from outside of Kentucky and delivered to a purchaser in Kentucky regardless of the f.o.b. point or other conditions of sale;
  - Gross receipts from the lease, rental or other use of real property located in Kentucky;
  - Gross receipts from the rental, lease or other use of tangible personal property located in Kentucky during the entire tax period;
  - Gross receipts from the rental, lease, or other use of tangible personal property located within and without Kentucky during the tax_period based upon the ratio which the time the property was physically present or was used in Kentucky bears to the total time or use of the property everywhere during such period;
  - Gross receipts from the provision of services performed entirely in Kentucky during the tax period;

  - o Gross receipts from the provision of services performed within and without Kentucky during the tax period based on the ratio which the time spent in performing such services in Kentucky bears to the total time spent in performing such services everywhere.
  - o Gross receipts from intangible property received by a business with a commercial domicile in Kentucky;
  - o Gross receipts from intangible property if the intangible has acquired a Kentucky business situs;
  - o Gross receipts from franchise fees received from a franchisee located in Kentucky; and
  - o Gross receipts from the distributive share of net income received from a general partnership that is required to file a Kentucky income tax return under the provisions of KRS 141.206.

- ➢ The expanded corporation income tax will apply to:
  - ▪ Corporations (C-corporations & S-corporations)
  - ▪ Limited liability companies (LLCs)
  - ▪ Limited liability partnerships (LLPs)
  - ▪ Limited Partnerships (LPs)

- ➢ The following entities will be exempt from the tax:
  - ▪ Financial institutions subject to the bank franchise tax
  - ▪ Savings and loan associations
  - ▪ Banks for cooperatives
  - ▪ Production credit associations
  - ▪ Insurance companies
  - ▪ Corporations exempt from taxation under Section 501 of the Internal Revenue Code
  - ▪ Religious, educational charitable, or like entities not organized or conducted for profit
  - ▪ Contract printers under special circumstances
  - ▪ Open-end registered investment companies (exempt from alternative minimum calculation only)
  - ▪ Public service companies subject to tax under KRS 136.120

    (exempt from alternative minimum calculation only)
  - ▪ A fluidized bed energy production facility (exempt from alternative minimum calculation only)
  - ▪ An alcohol production facility (exempt from alternative minimum calculation only)

- The income taxed at the entity level for partnerships, LLCs and S-corporations will be distributed and taxed at the partner, member or shareholder level for individual partners, members or shareholders and a nonrefundable credit for the tax paid at the entity level will be provided to the individuals based on their percentage of ownership.
    - The credit on pass-through income will be limited to the amount of tax owed on the pass-through income.
    - The credit shall not carry forward.
    - The language of the credit will mirror the current treatment of income taxes paid in other states: KRS 141.070 (1) –*The application of such credits shall not operate to reduce the tax payable under this chapter to an amount less than would have been payable were the income from the taxable entity be ignored.*
- The distributive share of a partnership's or S-corporation's net operating loss will pass through to the individual partner or shareholder.
- For any business entity whose ownership is not comprised of individuals, there will be no pass through of income or loss.
- The net income portion of the tax will incorporate many of the provisions of the existing corporation income tax.
- The following changes from current income tax law will apply to the expanded corporation income tax:
    - A common three-factor apportionment (double-weighted sales factor) formula will be applied to the net income of those entities that are doing business within and without Kentucky.
    - Consolidated returns will be mandatory for affiliated groups of business entities that have nexus with Kentucky, requiring a "nexus consolidated return."
    - Deductions taken for payments made between affiliated companies for intellectual property (franchise fees, trademark fees) will not be allowed.
    - A "doing business" nexus standard will be used. This standard is broader than the current physical presence nexus standard.
    - Net operating losses may be carried forward and used as a deduction under the new calculation. The alternative minimum calculation will not increase the amount of net operating loss carryforward utilized for a tax period.
    - Net operating loss carrybacks will not be allowed.

- Under this proposal, sole proprietorships and general partnerships will not be taxed at the entity level. The owners of these business entities will continue to be taxed as they are presently taxed except that multi-state general partnerships will use a 3-factor formula to apportion their income to Kentucky.

- Economic development tax credits that "pass-through" to individual shareholders (S-corporations) or partners under current law will be taken at the entity level.

Background

- Under current law, some multi-state business entities are able to use a single factor formula to apportion their income to Kentucky. An example of such a business entity would be an LLC with corporate members that is taxed as a partnership.

- A multi-state C-corporation presently apportions its income to Kentucky using a three-factor formula.

- Taxpayers may elect to file a consolidated return under the current corporation income tax law.

- Some corporation income taxpayers presently reduce or eliminate taxable income in Kentucky by taking a substantial deduction for intellectual property.

- Kentucky is the only state with a physical presence corporation income tax nexus standard of having property or payroll located in this state.

Rationale for proposal

- Repeal of the corporation license tax will help stimulate Kentucky's economy. Corporations have argued that the license tax is a discouragement to locate or expand operations in Kentucky.

- Reducing the maximum corporation income tax rate from 8.25% to 6% will help stimulate Kentucky's economy. Corporations have argued that the present top corporation income tax rate of 8.25% is a discouragement to locate or expand operations in Kentucky.

- Expanding the corporation income tax to be an entity level tax on all businesses with limited liability protection and closing various income tax "loopholes" will result in a broader based tax than the current corporation income tax. Under current law, corporations have increasingly utilized "loopholes" to minimize their corporation income tax liability in Kentucky, thus, resulting in a reduced base for that tax.

Fiscal Impact (in Millions of Dollars)	**FY 05**	**FY 06**
Repeal Corporation License Tax	**-79.6**	**-196.3**
Lower Top Rate on Corp. Income tax From 8.25% to 6%	**-24.2**	**-69.6**
Closing Corporation Loopholes	**17.2**	**66.1**
Mandatory Nexus Consolidated Filing	3.6	10.0
Disallow Excessive Deductions to Affiliates	3.0	10.0
Disallow NOL Carrybacks	1.7	5.0
Change NEXUS Standard	1.8	5.6
Three-Factor apportionment on LLE's	7.1	35.5
Apply Alternative Minimum Calculation To Corporation Income Tax (estimate includes C-Corps only, tax rate of 9.5 cents per $100 (.00095) of gross receipts)	**0.0**	**96.7**
Impose Minimum Tax Due of $250	**0.0**	**6.6**
Broaden Corporation Income Tax Base to Include All Business Entities w/Limited Liability Protection, With Alternative Minimums, Loophole Closings & Common 3-Factor Apportionment	**22.3**	**106.5**
Net Fiscal Impact	**-64.3**	**10.0**

The fiscal impact assumes:

- The cost estimates for the repeal of the corporation license tax reflect the retroactive reversal of the ITW decision.
- Estimated payments will be required from all entities subject to the tax.
- The repeal of the license tax will apply to tax periods beginning on or after January 1, 2004.
- The corporation income tax provisions will apply to taxable years beginning on or after January 1, 2005.

Impact on taxpayers

- Any corporation currently subject to the license tax will benefit from this proposal, including holding companies that stand to pay more license tax as a result of the Illinois Tool Works (ITW) decision.

- The reduction of the maximum corporation income tax rate from 8.25% to 6% will reduce the corporation income tax liability of many corporations.

- Multi-state LLCs, LLPs, and LPs with corporate ownership that presently apportion pass-through income to Kentucky using a single-factor formula will pay more because they will pay tax at the entity level using a three-factor apportionment formula.

- Individual partners, members and shareholders will continue to be able to offset their share of a loss distributed by a partnership, LLC or S-corporation against income from other sources.

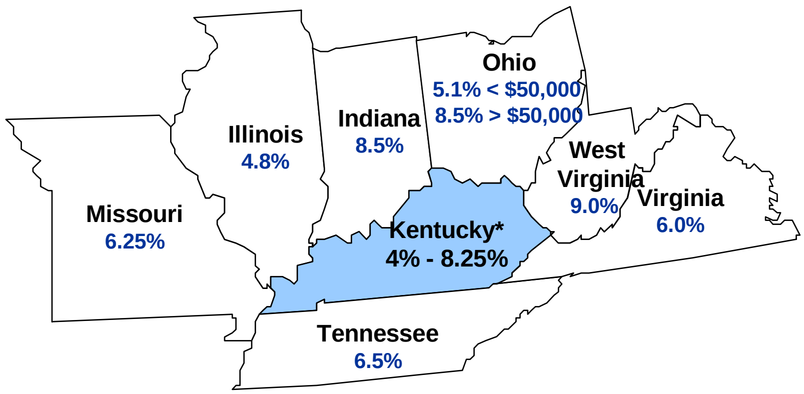
- Affiliated groups of corporations that have filed a separate entity return in lieu of electing to file a consolidated return will potentially have a greater corporation income tax liability.

Impact on competitiveness vs. other states

- Reducing Kentucky's top corporation income tax rate to 6% will put the Commonwealth in a tie with Virginia for having the second lowest top corporation income tax rate in comparison to its border states. Illinois has the lowest rate among border states. All other border states will have a higher top rate.

- Repeal of the corporation license tax will give Kentucky a competitive advantage over most of its border states. Of the border states, only Indiana and Virginia do not impose a corporation license or franchise tax.

Corporate Tax Rates for Surrounding States



* Kentucky's 8.25% rate applies to taxable income greater than $250,000

Source: CCH, State Tax Handbook 2003

Corporate License Tax for Surrounding States

Source: CCH, Inc. and Department of Revenue research

PROPERTY TAX MODERNIZATION

Intangible Personal Property Tax Modernization

Proposal

Exempt intangible personal property from state taxes.

Under the authority of Section 170 of the Constitution of Kentucky, all references to the general intangible personal property tax would be stricken from the Kentucky Revised Statutes, and it would be listed as exempt.

Rationale for proposal

- The general intangible property tax currently applies to a variety of items remaining after the *St. Ledger* court case ended the taxation of stocks and stock related items (e.g., mutual funds) in 1997. This tax, all of which is state revenue, now applies primarily to businesses and business activities, and some individuals. The tax remains on money market accounts, bonds, loans, notes, mortgages receivable, land contracts, trusts, cash, deposits, accounts receivable and other types of intangible personal property. Approximately 61% of intangible property tax revenues are derived from the tax on business accounts receivable.

- The present intangible property tax law is very complex. Taxpayers and the Department of Revenue must make careful distinctions between taxable and nontaxable types of intangible property. The complexity of the intangible property tax makes it difficult to understand and contributes to misconceptions in studies of comparative tax burdens.

- The fact that Kentucky continues to have an intangible property tax, however diluted by the *St. Ledger* case, may deter businesses from locating in Kentucky. Most states do not tax intangible property.

- Compliance and enforcement of the intangible property tax are difficult. Its complexities result in numerous taxpayers being unaware of their obligations. Because of this, noncompliance is believed to be widespread.

Fiscal impact

- This proposal would involve a loss to the General Fund of approximately $35.3 million in FY 2006, $37 million in FY 2007, and $38.7 million in FY 2008. No local revenue impact would be involved other than a loss of sheriffs' commissions.

Impact on taxpayers

- This proposal would relieve over 36,000 taxpayers from the necessity of filing intangible property tax returns.
- This proposal would contribute to simplicity and equity in the Kentucky tax structure.
- This proposal would eliminate administrative and compliance problems.
- Elimination of the general intangible property tax may enhance Kentucky's competitiveness with regard to business location decisions.
- This proposal is consistent with the recommendations contained in the 1995 report of the Kentucky Commission on Tax Policy and the Barents Group, which characterized the current intangible property tax structure as a "Red Flag" for reform.
- This proposal does not impact the public service company property tax, bank franchise taxes, savings and loans taxes, domestic life insurance company taxes, or bank deposits taxes.

Impact on competitiveness vs. other states

- 33 states have no remaining intangible property taxes.
- The other 17 states tax only a few types of intangible property or have reduced the rates to the extent that intangible property is practically exempt.
- Of Kentucky's seven surrounding states, none has a substantial intangible property tax at the state or local level.

Intangible Personal Property Taxation for Contiguous States

Source: Commerce Clearing House, Inc.

REAL PROPERTY TAX RATE MODERNIZATION

Proposal

Revise the annual procedure for setting the state real property tax rate, allowing the state to exclude “new property” from the 4% limit on the increase in revenues from the prior year.

KRS 132.020, the statute that specifies state property tax rates, would be amended to provide that the state real property tax rate (currently 13.3¢ per $100) be calculated in a manner similar to that allowed for local governments: new property would be excluded from assessment and revenue figures.

Rationale for proposal

- The state real property tax rate has declined steadily from 1979 to the present as a result of the enactment of changes to KRS 132.020, generally known as “House Bill 44”. These provisions limit the state to a 4% increase per year in real property tax revenues, based on total assessment growth. The rate was 31.5 cents per $100 of assessed value in 1977 and 1978, and has decreased to 13.3 cents per $100 of assessed value for 2003. The state real property tax rate is set each year by July 1.

- Property tax receipts have declined steadily as a percentage of the General Fund from 10% in 1980 to the current level of about 6%.

- The current rate setting methodology does not allow the General Fund to benefit from new property growth, unlike the situation for local governments that exclude new property from the base to retard the decline in the rate.

Fiscal impact

- The revised annual rate setting procedure would slow the 25 year decline of the state real property tax rate.

- Under the current assessment growth rate, the rate would stabilize, resulting in an estimated net gain for the General Fund of $3.4 million in FY 2006, $7.2 million in FY 2007, and growing proportionately thereafter. No local revenue impact would occur.

Impact on taxpayers

- This proposal would produce a modest revenue increase and slow the decline in the relative contribution of property taxes to the General Fund, while helping the General Fund gain some elasticity in a growing economy.

- A change in the annual state real property tax rate calculation method would not increase administrative costs.

- This proposal would allow property tax receipts in the General Fund to keep pace with growth in the real estate economy, and bring more growth and stability to total revenues.

- Increased property tax collections would increase sheriffs' commissions.

- Kentucky's state real property tax rate remains relatively high compared to most other states; a study of overall effective property tax rates, including all local levies shows that Kentucky is competitive.

Impact on competitiveness vs. other states

- Only fifteen states, including Kentucky, levy a general real property tax rate. In the remaining thirty-five states, property taxes are levied at the local level.

- Of the surrounding seven states, only three (Indiana, Missouri, and West Virginia) have a state tax on real property, and their rates are significantly lower than Kentucky's rate.

- The study "Comparative Analysis of Kentucky's Tax Structure", performed in December 1999 by the Barents Group LLC, found Kentucky's overall effective real property tax rate, based on state and local rates, to be the lowest of the fifteen states surveyed (including all of the seven contiguous states).

- The study "Tax Rates and Tax Burdens in the District of Columbia—A Nationwide Comparison", performed by the Office of the Chief Financial Officer of the District of Columbia (2000), ranked Kentucky 31st of all fifty states and the district in residential real property tax rates.

Examples

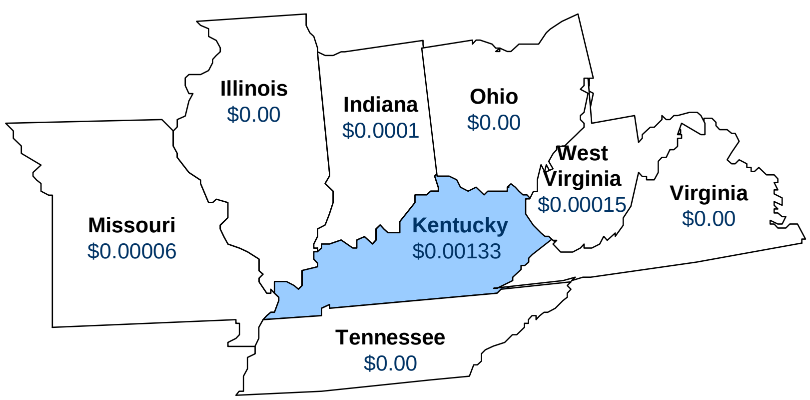
Under the proposal, new property is excluded from the total property tax base for the purpose of rate calculations. Given the projected property tax assessment growth expected for FY 2005, excluding the new property would have the effect of keeping the state property tax rate near the current level. For example, the owner of a $100,000 **residence** in Kentucky would pay $2 more in FY 2005 property taxes (property tax bills due in the fall of 2004) if the state real property tax rate remained at a rate of 13.3¢ per $100 in valuation. The state portion of the tax bill would be $133 versus $131. The total property tax bill, based on the average FY 2004 county, city and school district tax rates, would be $1,053.56 versus $1,051.56.

For property tax purposes, the average **agricultural value** of a Kentucky farm is $44,640. The typical farm owner would therefore pay 90¢ more in FY 2005 property taxes if the state real property tax rate remained at 13.3¢ per $100 in valuation. The state portion of the tax bill would be $59.37 versus $58.47. The total property tax bill, based on the FY 2004 Average County and school district tax rates, would be $377.39 versus $376.50.

The owner of the average **commercial or industrial property** in Kentucky, valued at the statewide average assessment of $317,917, would pay $6.36 more in FY 2005 property taxes if the state real property tax rate remained at 13.3¢ per $100 in assessment value. The state portion of the tax bill would be $422.83 versus $416.47. The total property tax bill, based on the FY 2004 average county, city and school district tax rates, would be $3,349.44 versus $3,343.08.

State Real Property Tax Rates

(Effective Tax Rates for Residential Property at Market Value)



KENTUCKY ENTERPRISE INITIATIVE ACT (KEIA)

Proposal

Create a new tax incentive program to replace and improve upon the Enterprise Zone (EZ) program that is expiring over the next few years. The program will:

- Extend to eligible companies statewide a refund of sales and use tax on building materials.
- Limit eligibility to certain industries, including tourist attractions, services, technology, and manufacturing, but allow regional or headquarters facilities in any industry to qualify.
- Give preference to companies locating in existing Enterprise Zones.
- Allow a sales and use tax refund for research and development equipment purchases.
- Cap fiscal year commitments to $20 million for building materials and $5 million for R&D equipment.

Background

Since 2000, certified companies have reported over 1,500 building material exemptions under the EZ program totaling $67.3 million. In addition, the Department of Revenue reports that approximately $2 million per year in building material exemptions are taken by non-certified businesses and residents of Enterprise Zones.

Enterprise Zone Exemptions Taken by Certified Firms ($ millions)

	Calendar Year			
	2000	2001	2002	2003
Building Materials Exemption	14.4	20.8	6.4	25.7
Total Exemptions Claimed	38.5	64.9	36.4	55.4

As the Enterprise Zones continue to expire over the next few years, this method of inducing new business formation and existing business expansion will be lost.

Furthermore, Kentucky has not historically provided sales and use tax relief for research and development equipment purchases outside the Enterprise Zones, and has never specifically targeted investment of this kind through the sales and use tax.

Rationale for proposal

Outside the current Enterprise Zones, Kentucky currently offers no general sales tax exemption to businesses for building materials. The expiration of the Enterprise Zones and consequent analysis by interested parties has spawned several reform proposals. Because the number of zones was limited to ten, businesses, legislators, and local officials in other areas of the state have shown interest in spreading the benefits of the program. Also, Kentucky offers no sales and use tax exemption for research and development with which to encourage investment in New Economy industries.

This proposal targets industries with significant capacity to grow, employ Kentucky residents, and compete in the New Economy. Eligible industries include the manufacturing, service and technology, and tourism sectors, as well as the headquarters or regional offices of companies in any sector. In order to preserve the original intent of the Enterprise Zone program, KEIA gives priority for the next three years to companies located within the existing Enterprise Zone boundaries, which under this program will be known as Preference Zones.

In keeping with the intent of the original EZ program, the minimum investment is set low enough ($100,000 for companies within the existing Enterprise Zone boundaries; $500,000 elsewhere) to allow small businesses to qualify for these inducements.

To improve accountability, which was one of the shortcomings of the EZ program, KEIA requires that projects and expenses be approved by the Kentucky Economic Development Finance Authority (KEDFA) prior to the start-up of the project, and that the program provide refunds of sales tax paid on eligible expenses, rather than a blanket exemption. These changes will significantly improve the Commonwealth’s ability to monitor and hold accountable the companies receiving tax incentives.

The program also recognizes that it must target incentives in a manner that is fiscally responsible, particularly in lean budget years. Capping the level of tax refunds that KEDFA can approve in any fiscal year at $20 million for building material expenses and $5 million for research and development equipment purchases ensures not only fiscal responsibility but that competition for these inducements will yield a maximum economic development impact to the state.

KEIA recognizes the arguments made in recent years concerning the cost and shortcomings of the current EZ program, but also that the state had made a 20-year commitment to these zones. KEIA allows these zones to expire on schedule to fulfill that commitment, but does not extend elements of the EZ program that were problematic, notably the motor vehicle usage tax exemption and the building material exemptions for non-certified companies and residents.

Finally, KEIA offers a modest, but important sales tax refund for equipment used in research and development as an incentive to New Economy businesses to locate and stay in Kentucky. These investments bring high-paying professional and technical jobs to Kentucky and foster growth and innovation in the regional economy. The $5 million cap on annual sales and use tax refunds will promote competition for these funds and will limit the Commonwealth's General Fund exposure.

Fiscal impact

The cost to the General Fund would be approximately $5.6 million in FY05 and $30.4 million in FY06. Because eligible companies cannot receive a refund for purchases of building materials until project completion or the end of the project life, the FY05 impact attributable to building materials is minimal. Likewise, many large projects approved in FY06 would not result in refunds until after FY06. However, the remaining FY05 commitments would be refunded in FY06. As such, the FY06 impact exceeds the cap. The following table summarizes the fiscal impact of this proposal on the General Fund (millions of $):

		FY05		FY06
Exemption of Building Materials	$	(2.0)	$	(24.0)
Cost of R&D Sales Tax Exemption	$	(3.6)	$	(6.4)
Total Impact of KEIA	$	(5.6)	$	(30.4)

The estimates of the refund of sales tax on building materials purchases were based on national data on Gross Private Fixed Investment in structures that was apportioned to Kentucky.[10] The estimates of the fiscal impact of the sales tax exemption on R&D purchases rely heavily on industry survey data on research and development expenditures and other states' estimates of purchases of tangible property for R&D.[11] The timing of the building materials refund impacts assumes that 10% of the FY05 commitment would be refunded that year, an additional 80% of the FY05 commitment would be refunded in FY06, and that 50% of the FY06 commitment would be refunded in FY06. The timing of the R&D refund impacts assumes a more rapid project completion time for the purchase of R&D equipment. Because of the January 1, 2005 starting date, 50% of FY05 R&D commitments would not be refunded until FY06.

Impact on taxpayers

Eligible companies outside the existing enterprise zones will benefit from the opportunity to apply for refunds under this proposal, as would firms inside Enterprise Zones that failed to meet the hiring or expansion criteria under that program.

Generally, the Commonwealth will benefit from this program because it provides a tax incentive that few other states offer. It addresses horizontal equity issues of the existing Enterprise Zone program by extending the benefits to firms regardless of their location. Furthermore, it recognizes the existing budgetary constraints by placing a cap on the state's General Fund exposure.

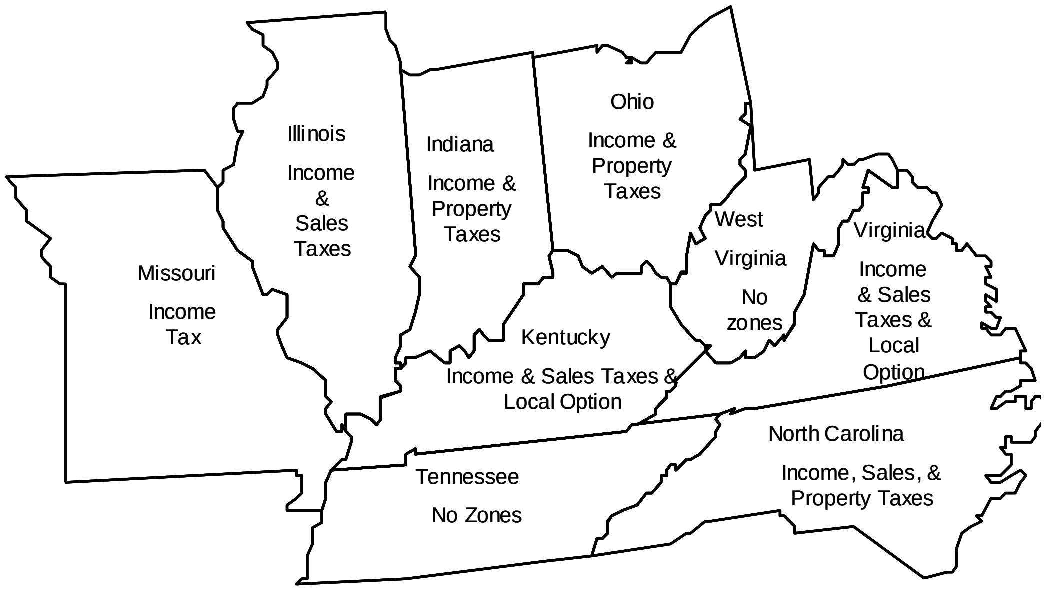
[10] These estimates were derived from Bureau of the Census, Annual Capital Expenditures Survey, Bureau of Economic Analysis National Income and Product Accounts tables, and monitoring data from the Kentucky Enterprise Zone Authority.
[11] National Science Foundation/Division of Science Resources Statistics. These data were derived from the NSF Survey of Industrial R&D and estimates of tangible purchases provided by the Ohio Department of Taxation.

Impact on competitiveness vs. other states:

Currently, 38 states have some form of enterprise zone program, although most are relegated to certain distressed areas of the state. Arkansas provides a sales tax exemption for building materials for qualified businesses statewide. Alabama has 27 zones statewide, which offer a sales tax exemption for building materials to qualified businesses. Ohio has enterprise zones in practically every county in the state, but does not offer a sales tax exemption. The entire state of South Carolina is designated an enterprise zone, but there is no sales tax exemption provided. Of neighboring states, only West Virginia and Tennessee have no enterprise zone program.

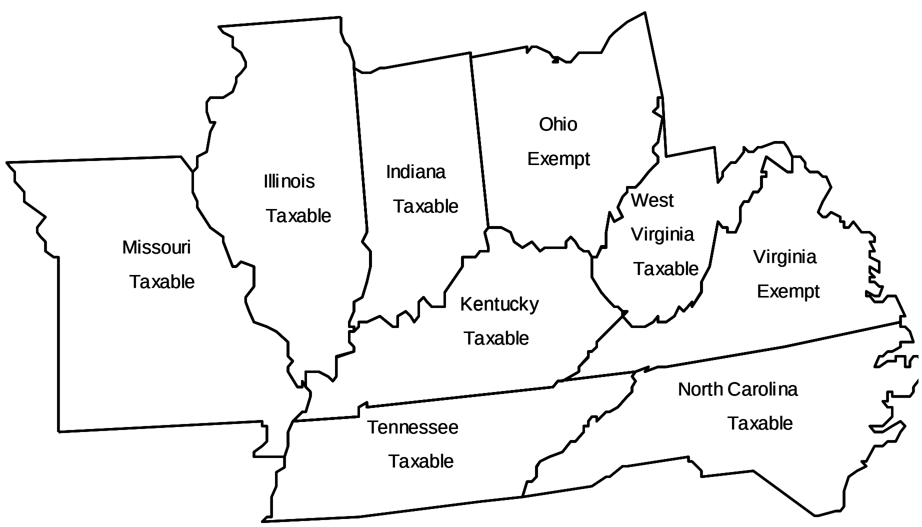
Sales tax exemptions for Research and Development equipment are becoming more popular. To date, fifteen states, including Arizona, Massachusetts, Oregon, and Virginia, have adopted laws exempting research and development equipment from sales taxation. Seven other states offer some sort of sales tax relief for research and development equipment, ranging from capping the sales tax at $300 in South Carolina, to tax deferral programs in Minnesota and Washington, as well as various other provisions to reduce sales tax on research and development equipment. Of the neighboring states, only Ohio and Virginia currently exempt R&D equipment from the sales tax.

Enterprise Zone Incentives in Neighboring States



Source: CCH State Tax Handbook

Sales Tax Treatment of Research and Development Equipment in Neighboring States



BACK-TO-SCHOOL SALES TAX HOLIDAY

Proposal

Create a 3-day sales tax holiday prior to the beginning of the school year, during which purchases of clothing, school supplies, and computers, printers and software would be exempt from sales and use tax.

- The first Friday, Saturday, and Sunday in August of 2004 and 2005.
- The following dollar limits are set on any eligible item:
  - Clothing - $150
  - Computers, printers - $1,500
  - Software – No limit
  - School supplies – No limit
- Sunsets after 2 years.
- Allows Department of Revenue to modify definitions as needed via regulation to correspond with changes that may be adopted by the Streamlined Sales Tax Implementing States. Allows department to issue educational bulletins.
- Allows retailers to elect to absorb and pay the sales tax without collecting the tax from the purchaser. Requires the retailer making such election to provide the purchaser with a receipt stating that the retailer has made the election and the amount of the tax that the retailer will absorb.
- Allows retailers to advertise that they will absorb and pay the sales tax instead of collecting it from the purchaser. Requires retailers who advertise in this manner to clearly state the items or categories and period which the retailer will absorb and pay the tax.

Rationale for proposal

A sales tax holiday is a way to alleviate the tax burden on working families, as well as a means of jump-starting local retail businesses. Over the last five years, sales tax holidays have proven to be a popular fiscal tool for state lawmakers.

Background

First instituted in New York in 1997, the tax holiday seeks to provide relief to taxpayers by instituting a temporary sales tax exemption on certain items for a specific period of time. The holiday typically occurs during August, the traditional back-to-school shopping period, and generally applies to merchandise connected with the new school year, particularly clothing and footwear. Computers and computer accessories have been added to that list in several states.

Impact on taxpayers

- Household and business taxpayers may save up to 6% on the purchase of certain necessities.
- Local retail businesses may see an increase in purchases during the holiday period, especially by consumers from bordering states.

Other states

In all, twelve states have enacted sales tax holidays: Connecticut; Georgia; Iowa; Massachusetts; Missouri; New York; North Carolina; Pennsylvania; South Carolina; Texas; West Virginia; and Vermont.

2003 State Sales Tax Holidays

State	Days	Items Included	Maximum Cost	1st Year	2003 dates
Connecticut	7	clothing and footwear	$300**	2000	August 17-23
Georgia	4	clothing, school supplies, computers,	cl - $100 ss - $20 cp - $1,500	2002	July 31-August 3
Iowa	2	clothing and footwear	$100	2000	August 1-2
Massachusetts	1	All consumer electronics products and most other consumer goods priced under $2,500	$2500	2004	August 14
Missouri	3	clothes and shoes, school supplies, software and computers	Cl -$100 Ss - $50 Cp- $2000	2004	August 13-15
New York (State & City)	14	clothing	$110	2003	August 26-September 1; January 26-February 1, 2004
North Carolina	3	clothing, school supplies, computers	cl,ss - $100 cp - $3500	2001	August 1-3
Pennsylvania	14	Computers, peripherals, and software	None	2000	August 5-12
South Carolina	3	clothing, computers, supplies	None	2000	August 1-3
Texas	3	clothing and footwear	$100	1999	August 1-3
Vermont	3	computers	$4000	2003	August 9-11
West Virginia	3	clothing, school supplies, computers	$100	2002	August 1-3

Fiscal impact

Using national data on personal consumption expenditures apportioned to Kentucky, the fiscal impact is estimated to be a General Fund loss of $7.4 million in FY05 and $7.5 million in FY06.

SALES AND USE TAX NEXUS STANDARD

Proposal

Expand the current sales and use tax nexus standard to include remote sellers who use their in-state store location, affiliate or other representative to exploit the marketplace and create an unlevel playing field with main-street retailers.

History

The 1992 Supreme Court decision known as *Quill Corp. v. North Dakota* confirmed that states cannot force remote sellers to collect sales and use tax unless the sellers have a physical presence in the state. To take advantage of this "loophole," some traditional retailers (bricks and mortar businesses) with a national or regional presence have begun to break out Internet sales into separate subsidiaries.

For example, a company has stores in every state, but it does not collect tax on sales it makes over the Internet because it claims that the actual seller is its subsidiary, a "dot.com" company. Products purchased on-line usually can be returned for refund or exchange at the local store. To the consumer there is no distinction between doing business with the local store or with the "dot.com" affiliate. The tax base continues to erode because of the increased activity of remote sellers in the Kentucky market.

Effective date: October 1, 2004

Fiscal impact: $1.0 million in FY05 and $1.0 million in FY06

Trends in electronic commerce activity

- Recent reports indicate that 63% of Kentucky adults now have Internet access.
- Online sales to U.S. consumers reached $54.9 billion in 2003.
- Even though purchases from remote sellers is increasing, voluntary use tax reporting on Kentucky individual income tax returns is flat and even declining slightly each year (a high of $836,258 in 1996 to $793,789 in 2003).
- Conservative estimates indicate that General Fund losses from Internet purchases could approach $200 million in 2004. However, in order to realize the full impact, federal legislation requiring remote sellers to collect the tax for states would be needed in addition to the proposed changes to Kentucky's sales and use tax nexus standard.
- The business community continues to exploit the market place through the use of "dot.com" affiliates. The various retail activities of affiliates are

interdependent and have developed far beyond the pattern examined in the *Quill* decision.

Benefits to strengthening nexus standards

- Main street merchants will be helped to compete on a more equal playing field.
- Some tax base erosion will be eliminated by minor changes to current nexus standards.
- Consumers will have tax collected at the point of sale rather than having to report their use tax liability voluntarily.

COST/BENEFIT STUDY OF ALL EXEMPTIONS AND EXCLUSIONS IN THE SALES AND USE TAX LAW

Proposal

The *JOBS for Kentucky* plan calls for the Legislative Research Commission to conduct an in-depth cost/benefit analysis of all statutory exemptions and exclusions in the sales and use tax law to determine if the exemptions are resulting in a positive economic impact on the Commonwealth.

Background

Kentucky enacted its current sales and use tax in 1960, applying the tax to the sale of all tangible personal property unless exempted by law, and did not tax the purchase of any services unless specified by law. At the time of enactment, exemptions from the tax-included purchases of manufacturing machinery for new and expanded industry, coal purchased for generating electricity, and other miscellaneous purchases. Since 1960, many category- and use-based exemptions have been enacted. The major categories of goods exempted from taxation and the year of the exemption are:

Prescription medicines (1971)
Food purchased for home consumption (1972)
Residential utilities (1979)

Many other items of lesser significance have also been exempted over the years. Other exemptions apply not to the category of good being purchased, but rather are extended to the purchaser or user. At the time of enactment, the sales and use tax exempted for many types of businesses the purchase of energy that exceeds three percent of the cost of production. Business's purchases of goods to be resold at the retail level were also exempted, as were purchases by state and local governments. The law gave merchants a reimbursement to compensate them for the trouble of collecting and remitting the tax. User-defined exemptions have been expanded over the years. Major beneficiaries of use-based exemptions or credits include:

Numerous exemptions for farming and agriculture (1960-2003)
Non-profit, educational, charitable and religious institutions (1976)
Air carriers' exemption for repair and replacement parts (1982)
Businesses and residents in Enterprise Zones (1992)

As in the category-based exemptions, many other specific use-based exemptions have been created with lesser significance. At this point in time, the category- and use-based exemptions and credits have grown until their estimated cost in FY04 ($2,269.7 million) is almost as large as estimated revenues from the tax ($2,402.7 million).

Rationale for the proposal

The proliferation of sales tax exemptions has not progressed toward any identifiable goal or policy directive, but has evolved over time as the perceived need has arisen. Thus, no systematic review or evaluation of sales tax exemptions has been undertaken that compares the benefits received by businesses and individuals to the costs borne by the state. The erosion of the sales tax base has been an expressed concern in all major studies of Kentucky's tax structure. A cost/benefit study will help measure the effectiveness of the exemptions and will help identify which exemptions have and have not achieved their intended objectives.

INCREASING TOBACCO TAXES
(Cigarettes and Other Tobacco Products)

Cigarettes

Proposal

Impose a $.26 surtax per pack of 20 cigarettes. In addition, impose an equity assessment on each pack of cigarettes sold in Kentucky manufactured by Non-Participating Manufacturers (NPMs) of the Master Settlement Agreement (MSA), with a credit given for qualified escrow payments made.

Effective date: August 1, 2004

Present law

An excise tax of 3 cents per pack of twenty cigarettes is paid at the wholesale level. Licensed stamping agents affix a stamp on each package to demonstrate evidence of excise tax payment. The proposal would add a twenty-six-cent surtax on each pack, to be paid by stamping agents at the time of stamp purchase.

Rationale for proposal

The economic rationale for taxing cigarettes at a higher rate is that demand for cigarettes is inelastic, and efficiency losses (or so-called excess burdens) are minimized due to the reduced behavioral response. These reduced behavioral responses were evident in the dynamic scoring of the tax modernization plan. The static increase in revenue generated through the cigarette tax was roughly identical in magnitude to the static cuts in the individual income tax. In a dynamic scoring setting, however, the simulative effect of cutting income taxes far outweighed the loss of economic activity from the cigarette tax.

A second benefit of taxing cigarettes involves the exportation of a small portion of the tax base. Since many non-Kentuckians purchase cigarettes in the state due to the low taxation, a bump in the cigarette tax will slightly augment the portion of total Kentucky taxes paid by non-residents.

In addition to the economic rationale, a higher excise tax represents a user fee on tobacco products that mirrors the costs to society in terms of higher Medicaid costs and the higher cost of private insurance. This external cost borne by society is partially recovered by a tax on the product, but the scales are tipped at the current level of 3 cents per pack. By imposing the 26-cent surtax, the costs on society of smoking are more in balance with the revenues generated through taxation.

The equity assessment will apply to manufacturers of cigarettes who are not participants in the MSA, or Non-Participating Manufacturers. A non-refundable credit will be given to the companies for the residual payments made into qualified escrow payments as required by KRS 131.602.

Fiscal impact

$164.6 million in FY05; $160.1 million in FY06. This is comprised of the $.26 surtax: $150.6 million in FY 05, and $146.1 million in FY 06; and the equity assessment of $.39: $14.0 million in both fiscal years.The effective date for the surtax and assessment would be August 1, 2004.

Estimates assume an **inventory or floor tax**. An inventory tax would require any seller of cigarettes, both at wholesale and retail, 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.

Recent legislative bills addressing the cigarette tax have structured the tax increase as the imposition of a cigarette surtax rather than an excise tax. This drafting technique was implemented to avoid unnecessary large increases in vendor compensation. Pursuant to the enacted budget, and notwithstanding current law (KRS 138.146), vendors receive $0.15 in compensation for each $3.00 increment in excise stamps purchased. If the desired tax rate is $0.50 per pack, and if the tax increase was in the form of an excise tax, compensation for 100 stamps would be $2.50. If the same 50 cents per pack were raised through a 47-cent surtax and a 3-cent excise tax, the compensation for the same 100 stamps would remain at $0.15.

Other Tobacco Products

Proposal

Kentucky currently imposes the general sales tax on other tobacco products ("OTP"), but does not levy an excise tax. This proposal would impose an excise tax on OTP, including but not limited to smoking tobacco, cigars, little cigars, chewing tobacco, and snuff. The tax rates are as follows: Snuff: 9.5 cents per ounce or major fraction thereof, equal to 9.5 cents per tin; Chewing tobacco: 3.17 cents per ounce or major fraction thereof, equal to 9.5 cents per envelope; Smoking tobacco and Cigars: 10% of wholesale price.

Effective date: August 1, 2004

Surrounding states

Only three states (plus the District of Columbia) do not currently impose an excise tax on OTP (KY, VA, and PA). Of the 47 states with an excise tax, 31 base the tax on wholesale selling prices, 13 states use manufacturer price (which is the price the manufacturer charges each wholesaler), and 3 states tax other tobacco products by the ounce. Rates for the surrounding states are displayed on an accompanying map.

Rationale for proposal

As with taxing cigarettes, the primary economic rationale for taxing other tobacco products involves the inelastic nature of demand for these products. In addition, imposing a small tax would put Kentucky more on par with the surrounding states.

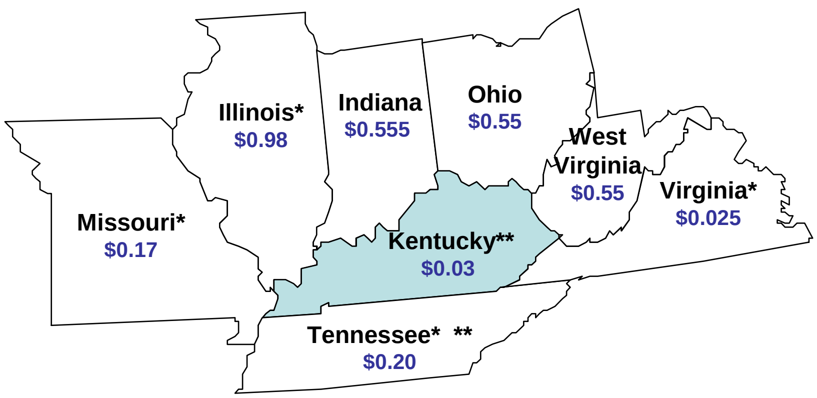
The relative taxes on tobacco products in this proposal reflect the growing data from scientific studies that although smokeless tobacco poses some risk, those health risks are significantly less than other forms of tobacco products. It also acknowledges that some in the public health community recognize that tobacco harm reduction should be a complementary strategy to any public health policy towards tobacco products. Taxing tobacco products according to relative risks is a rational tax policy and may well serve the public health goal of reducing smoking-related mortality and morbidity and lowering health care costs associated with tobacco related disease.

Fiscal impact

FY 2005: $4.0 million; FY 2006: $4.8 million. The impact in the first year is affected by timing, as collections will be restricted to 10 months due to implementation on August 1.

State Excise Tax Rates on Cigarettes

(Per Pack; Current Rate)

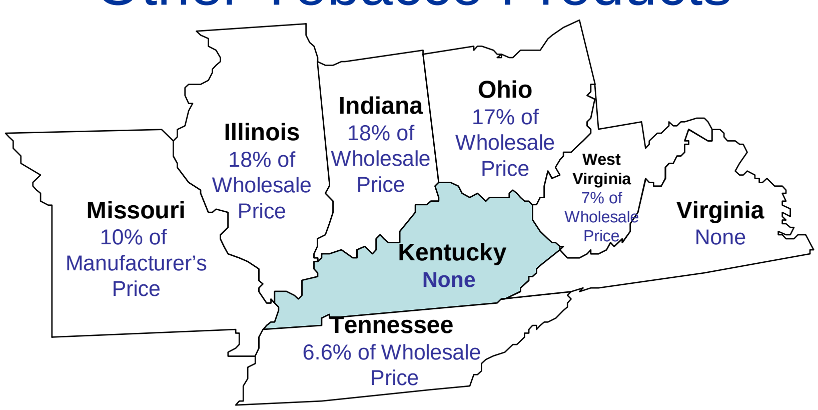


* Counties and cities may impose an additional tax on a pack of cigarettes: Illinois $0.10 to $0.15; Missouri $0.04 to $0.07; Tennessee $0.01 and Virginia $0.02 to $0.15.

** Dealers pay an additional enforcement and administrative fee of $0.01 per pack in Kentucky and $0.05 in Tennessee.

Source: Federation of Tax Administrators

State Excise Tax Rates on Other Tobacco Products



Source: Federation of Tax Administrators

SIMPLIFY / RAISE ALCOHOLIC BEVERAGE TAXES

Proposal

Eliminate the case sales tax on distilled spirits and the excise tax on distilled spirits, beer and wine. Increase the wholesale sales tax on distilled spirits, beer and wine.

	Distilled Spirits	*Beer*	*Wine*
Wholesale Sales Tax	15.53%	11.94%	12.86%

Different rates are necessary to keep from shifting the current tax burden among the categories.

Effective date: August 1, 2004

Present law

There are three taxes levied on distilled spirits and two taxes levied on both beer and wine. Both the case sales tax on distilled spirits and the excise tax on all three categories have shown little growth over the past three years. All growth in this industry comes from the wholesale sales tax which is levied on gross receipts.

	Distilled Spirits	*Beer*	*Wine*
Excise Tax	$1.92 gal.	$2.50 bar.	$0.50 gal.
Case Sales Tax	$0.25 per case	NA	NA
Wholesale Sales Tax	9%	9%	9%

Note: Distilled spirits, beer and wine sold by the drink are also subject to 6% sales tax.

Rationale for proposal

Simplification and modernization of the taxes levied on alcoholic beverages in Kentucky is long overdue. There are currently three taxes levied on distilled spirits and two taxes levied on beer and wine at the wholesale level. The excise tax levied on distilled spirits, beer, wine and the distilled spirits case sales tax generate a very small stream of revenue. As the basis for these taxes is volume, receipts from these taxes represent only 22% of the total amount of revenue on alcoholic beverages. The remaining 78% of the revenues are generated through the 9% wholesale sales tax on these products.

By repealing both the excise tax on distilled spirits, wine and beer as well as the distilled spirits case sales tax, and increasing the wholesale sales tax, Kentucky can remove the administrative burden on both the taxpayers as well as the

Department of Revenue, and capture growth in the tax revenues commensurate with future increases in the prices of the products

This proposal will increase the rates on these products based upon their current tax burden. Thus each will have its own wholesale sales tax rate. Of the surrounding states, Kentucky is the only state that levies a wholesale sales tax. All others levy their tax at the retail level. Tennessee levies an additional on-premises tax of 15 percent.

Fiscal impact

General Fund Increase $8.8 million in FY 05 and $10.0 million in FY 06

Impact on consumers

The consumer of alcoholic beverages will see little impact. For instance:

- The total cost added to a $1.75 liter of bourbon retailing for $20 would be 34 cents.
- The total cost added to a liter of wine retailing for $10 would be 22 cents.
- The total cost added to a 12-pack of beer retailing for $8 would be 12 cents.

Comparison with other states

- **Distilled spirits**
- Kentucky has the lowest excise tax rate
- Tennessee is the highest at $4.40 per gallon - Kentucky's rate is $1.92 per gallon

- **Wine**
- Kentucky is the 3rd lowest at a rate of $.50 per gallon
- Virginia is the highest at $1.51 per gallon
- Tennessee the next highest at $1.21 per gallon

- **Beer**
- Kentucky is the next to the lowest at $.08 per gallon
- Only Missouri has a lower rate of $.06 per gallon
- North Carolina is the highest at $.53 per gallon
- Tennessee's rate is $.14 per gallon

Note: The Malt Beverage Educational Fund, a program designed to discourage teen drinking, will continue to receive 1% of the Beer Wholesale Sales Tax.

SIMPLIFY COMMUNICATIONS SERVICES TAXES

Proposal

Apply a single communications excise tax on all communications services such as intrastate and interstate phone service, cable service, and direct broadcast satellite (DBS). This tax will replace the current 6% sales tax on intrastate and interstate phone service, the PSC property tax on communications service utilities, and the city and county franchise fees. The proposed tax rate is 7.62%.

State Taxes Replaced:	Local Taxes Replaced:
➢ 6% sales tax on phone service ➢ PSC property tax	➢ PSC Property Tax (school districts, cities, counties and special districts) ➢ Franchise Fees (cities and counties)

Effective date: January 1, 2005

Rationale for proposal

The telecommunications tax structure in Kentucky, at both the state and local level, is still governed by the original 19th century franchise tax concept. This is no longer appropriate. The same phone service provided by a regulated wireline phone company is also available from cable, wireless phones, or through the Internet. The franchise no longer exists. It's time to modernize a 19th century tax structure for the 21st century reality.

The introduction of a single excise tax allows for the taxation of communications services at the end-user level. The tax is only on the service, whether it is telephone or multi-channel programming, and is independent of the delivery method. This method of taxation not only addresses the current needs of the industry and consumers, but also allows for changes taking place in the communications services industry. The delivery protocol for services is expected to continue to change. A tax on the end-product ensures that the tax structure is independent of the transmission protocol. The communications excise tax also addresses the disparity of the tax base between cable and direct broadcast satellite (DBS). This problem was recently highlighted by a court decision[12] that held that the franchise value of both cable and DBS should be taxed similarly. Under Kentucky's current tax structure DBS is not subject to taxation at the state level and is prohibited from taxation at the local level by federal law.

12 Insight Kentucky Partners II, L.P. v. Revenue Cabinet, KY TAX REPORTER CCH) ¶202-722 (Franklin Cir. Ct., Division II, Civil Action No. 01-CI-01528, February 5, 2004 opinion and order)

The new tax would replace the following taxes with a single excise tax:

- *Sales tax*. The tax is levied by the state on all telephone services including the standard monthly charge, intrastate and long-distance calls.
- *Local franchise fee*. This refers to the county and city franchise fee which is a local jurisdictional tax or license fee imposed in the awarding of a franchise. It is normally settled through a twenty-year contract. The fee ranges from 0% to 5.67%. It is paid by most telephone and cable companies.
- *Public service company property tax* (also called the franchise value tax). This is assessed by the state, and the assessment is certified for local taxing districts. Both the state and local authorities collect this tax. The tax is levied on both telephone and cable companies.

The new statewide communications excise tax would:

- Eliminate local city and county franchise fees imposed on in-state telephone and cable services.
- Eliminate state and local property tax imposed on the franchise value of telephone and cable companies.
- Eliminate tax on switch access charges and other telecommunications services for resale.
- Guarantee local governments a fixed amount to replace the PSC property tax and franchise fees, and provide a percentage share in any growth to the communications excise tax base.
- Tax all end-users of communications services on the same basis.
- Provide a solution for the erosion of the PSC property tax from both legal challenges and the decline in assessed value.
- The excise tax, being an end-user tax, will have higher compliance and predictability. This will help local governments by providing them with a steady, and uncontested, income flow.

Fiscal impact

After guaranteeing local political subdivisions their current tax base, the net effect to the General Fund is $14.2 million in FY05 and $35.6 million for FY06.

- The effective date for the new tax would be January 1, 2005 because the tax replaces a property tax that is levied on a calendar year basis.
- Receipts from the telecommunications excise tax are distributed to both the state and all local jurisdictions that levied a PSC property tax and franchise fee.

Local government distribution

The communications excise tax will be collected at the state level by the Department of Revenue. The tax receipts[13] will be distributed first to local governments at a “hold harmless” amount of $39.3 million. This is the estimated amount of local government receipts from both franchise fee and the assessed value of the PSC property tax. The rest of the excise tax money, after deducting DBS receipts estimated at $18.9 million, will be divided between the state and local governments based upon the historical proportional share of taxes on this industry. The local government portion is 15.6% and the state share is 84.4%[14] of the total. If the 15.6 percent allocation is less than the local hold harmless amount, local governments will still receive the base amount of $39.3 million.

Local jurisdictions have a stake in the communications excise tax revenue. These jurisdictions include city and county governments, school districts, and a range of special districts like libraries, fire districts, and ambulance services. The final distribution to each of these taxing units will be determined by the amount of money they have collected in the past from these taxes, i.e. their tax effort. Each local jurisdiction’s percentage of tax collections reported to the Department of Revenue will form the basis of the monthly payment from the local hold harmless fund. In addition any money that is in excess of the hold harmless fund will be allocated to the taxing districts as a proportion of their tax effort.

Impact on taxpayers

- Increases the tax burden on all communications service subscribers.
- Businesses, specifically in the area of cable and telephony, that pay multiple taxes to numerous jurisdictions would now pay a single tax. This tax would be paid directly to the state instead of to over one-thousand taxing authorities.
- Telecommunications companies that pay access charges to other carriers will no longer be taxed on the access fee.
- DBS customers will be subject to taxation.

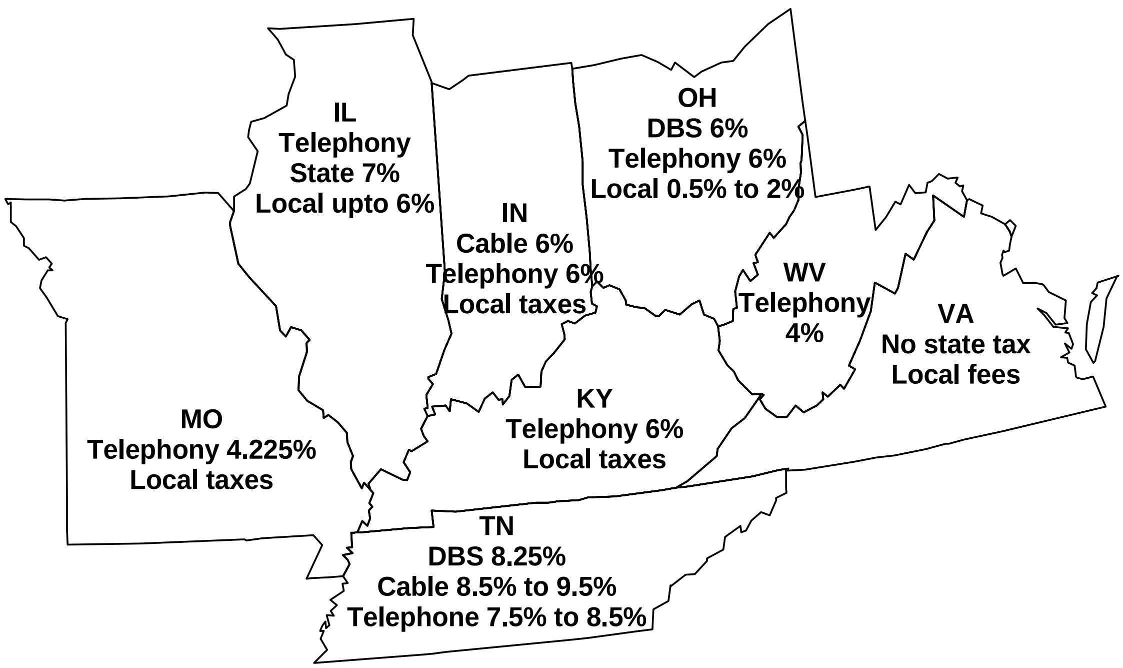
Impact on competitiveness vs. other states

- The new tax is an end user tax and does not put Kentucky-based communications companies at a disadvantage.
- Over twenty states tax DBS customers for satellite television services.

[13] A small deduction will be made to recompense communications service providers for collecting the tax and the Department of Revenue for processing and disbursement of the receipts.
[14] The 15.6% is local government share under current law of the total collections from telecommunications taxes.

- Ohio and Tennessee tax communications services, including DBS, at a higher rate than the proposed communications excise tax.
- Under the current system most small providers of communications services and DBS do not pay any local taxes in Kentucky. This tilts the balance against Kentucky-based businesses. The new tax would provide horizontal equity.

Communications Services Taxes in Surrounding States



Sources: Telephone conversation with tax administrators, February 2004.

TOURISM, MEETING AND CONVENTION DEVELOPMENT ACT

Proposal

Establish a Tourism, Meeting and Convention Development Act Fund and Impose a 1% statewide lodging, or transient room, tax. Use the proceeds to fund tourism development initiatives.

Rationale for proposal

It is estimated that when tourists visit Kentucky, 25 to 40% of their expenditures in the state are for lodging. Given Kentucky's geographical position and important interstate highway system, 80% of a statewide lodging tax would be borne by non-residents.

Research conducted by the Department of Travel in the Kentucky Commerce Cabinet concluded that every dollar spent on advertising promotion has resulted in a $30 dollar return on investment. The proceeds from the tax would be used to:

- Boost Kentucky's presence in the meetings, conventions and group travel market.
- Dramatically increase money available to the nine Kentucky tourism regions in the form of matching funds.
- Conduct expanded research that assists the state in determining likely visitor profiles; effectiveness of advertising and marketing efforts and the potential for new product development, such as Kentucky golfing trails.
- Grow consumer awareness of Kentucky as a travel destination through integrated advertising and marketing programs, with a special emphasis on the Internet. The Internet is the largest source of travel information now in use and continues to grow. In recent focus group research many respondents cited lack of knowledge about Kentucky as the main reason they have not visited before.
- Take advantage of tourism trends in niche markets through special promotion and development programs.

Background

State taxes

Under current law, the rental of any room, lodging, or accommodation for a continuous period of less than 30 days (prior to July 14, 1992, 90 days) by any hotel, motel, inn, tourist camp or cabin, or any other place in which rooms, lodgings, or accommodations are regularly furnished to transients for a consideration is subject to the sales and use tax. Weekly or monthly apartment rentals may be subject to tax if the rental facility regularly holds itself out to transients as providing short-term accommodations.

Local taxes

Like most states, Kentucky authorizes local governments to levy transient room taxes, with significant restrictions. Cities of all classes are authorized to levy and collect any and all taxes provided for in Section 181 of the Constitution. Currently, the cities of Barbourville, Berea, Cave City, Central City, Columbia, Elizabethtown, Fulton, Glasgow, Grand Rivers, Grayson, Hazard, Hopkinsville, Lexington, Louisa, Mayfield, Morehead, Mount Sterling, Murray, Nicholasville, Paintsville, Pikeville, Prestonsburg, Radcliff, Richmond, Williamsburg, and Winchester impose a local lodging tax. In total, these cites raised more than $4.3 million in 2001.

To fund local commissions for tourism and conventions, a 3% transient room tax, payable as a license tax rather than sales tax, may be imposed by a county or a city on transient room rentals at hotels, motels, inns, motor courts, or similar accommodations. An additional 1% transient room tax may be imposed to finance the operating expenses of a local convention center. Cities and counties operating as urban-county governments also may impose the transient room tax at an overall rate of 4%.

Cities of the first class are authorized to impose an additional transient room tax not to exceed 1.5% of the room rent. The additional tax requires approval of the local governing body and must be used to fund promotion of tourism and convention business. Counties that have formed multi-county tourist and convention commissions may impose an additional transient room tax of up to 1% for the purpose of promoting regional tourism and conventions. Also, a consolidated local government or a county that contains a city of the first or second class and that is not included in a multi-county tourist and convention commission may impose an additional transient room tax of up to 2% to promote tourism and conventions.

Counties with cities of the first class or consolidated local governments may impose an additional 1% transient room tax to fund the Kentucky Center for the Arts. An additional 2% transient room tax may be imposed by an urban-county government to defray the operating expenses of the Lexington Center Corporation and retire bonds for the Center's construction costs. An urban-county government may also impose an additional 1% transient room tax for buying rural and agricultural land for preservation and fostering tourism and recreation.

Gross receipts from customers used by a transient lodging business to pay the 3% transient room tax for commissions on tourism and conventions are included in customer gross receipts subject to the Kentucky sales tax on transient lodging. The transient room tax is a tax imposed on a lodging business rather than on its customers, and therefore becomes part of the business' costs that are recovered from customers through the selling price or gross receipts from room rentals. In effect, Kentucky sales tax is imposed on local transient lodging taxes.

Current Effective Hotel Tax Rates in Kentucky

Area	Local Rate	State Rate	Total Effective Rate
Louisville	7.50%	6.00%	13.95%
Lexington	6.00%	6.00%	12.36%
Northern Kentucky	4.00%	6.00%	10.24%
Ashland	5.00%	6.00%	11.30%
Bowling Green	4.00%	6.00%	10.24%
Paducah	6.00%	6.00%	12.36%
Owensboro	3.00%	6.00%	9.18%

Impact on taxpayers

Tourist attractions and related businesses would increase benefit as a result of increased promotion.

Tourists, 80% of whom are out-of-state travelers, would bear the increased cost, which on a $70 room would only be $.70 per night. Hotels near Kentucky's borders may suffer a minor reduction in occupancy rates.

Neighboring states

All neighboring states except Illinois tax lodging through their sales tax and have no additional statewide occupancy tax. Illinois exempts lodging from their sales tax but imposes a statewide lodging tax. All neighboring states authorize local options for lodging taxes.

Nationally, all but six states with a state sales tax apply the tax to lodging. Of those states, four impose a statewide occupancy tax. Eight states that apply the sales tax also apply a statewide occupancy tax.

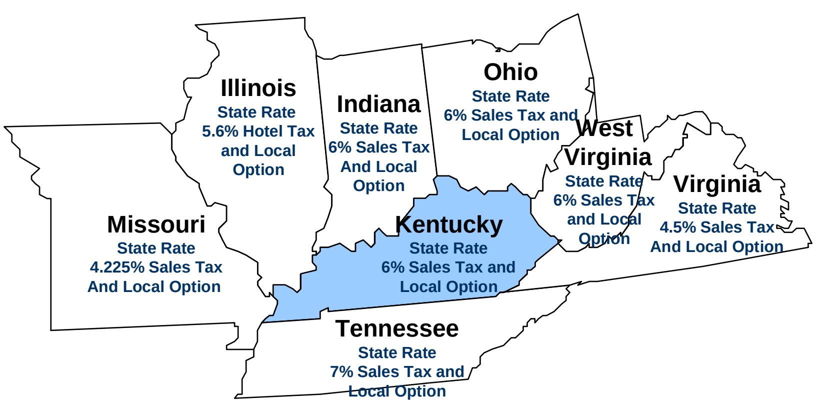
The additional funding for promoting tourism will allow the state to more readily compete for potential travelers. Kentucky currently ranks 31st in the country in both overall budget of the tourism office and advertising dollars spent to promote tourism. The addition of $8 to 9 million would raise Kentucky's ranking from 31st to somewhere between 8th to 14th in the nation.

When comparing only the 12 southern states – Kentucky, Tennessee, Georgia, Florida, Alabama, Mississippi, Louisiana, Arkansas, North Carolina, South Carolina, West Virginia and Virginia - Kentucky ranks 11th in advertising expenditures, ahead of only Georgia ($970,000).

Lodging Taxes in Nearby Cities

Area	Local Rate	State Rate	Total Effective Rate
Cincinnati, OH	11.50%	6.00%	17.50%
New Albany, IN	3.00%	6.00%	9.00%
Evansville, IN	6.00%	6.00%	12.00%
Nashville, TN	7.25%	7.00%	14.25%

Comparison of Lodging Tax for Contiguous States



Note: Commerce Clearing House, Inc.

Fiscal impact

The fiscal impact to the General Fund of a 1% statewide lodging tax would be $7.9 million in FY 05 and $9.9 million in FY 06 assuming an August 1, 2004 effective date.

These estimates are based on two separate methodologies that yielded similar results. The 1997 Economic Census of Kentucky[15] provides sales data for Kentucky establishments in NAICS 72111: Hotels (except Casino Hotels) and Motels. This industry comprises establishments primarily engaged in providing short-term lodging in facilities known as hotels, motor hotels, resort hotels, and motels. These data were forecast to 2005. Also, data from the Department of Revenue on sales tax by industry provided FY02 sales tax receipts for hotel and motel establishments. The FY05 figures are adjusted to account for an August 1, 2004 effective date.

[15] U.S. Bureau of the Census, 1997 Economic Census. Data on Kentucky sales viewed at http://www.census.gov/epcd/ec97/ky/KY000_72.HTM#N721