Reflections on tax reform

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Many types of taxes

In the United States, we have taxation with representation. Almost without exception, wherever we have representative government, we have taxes.

All levels of government levy taxes. The federal government levies taxes on, for example, income, estates and manufactured or processed goods, such as fuel, alcohol, and tobacco products. It imposes other taxes too. Similarly, states, like Kentucky, levy taxes on income, sales and use, and property - the so-called three legs of the revenue stool. They levy other taxes too on, for example, estates, gross receipts, capital, severance and processing of natural resources, insurance premiums, and sales of particular goods including fuel, alcohol and tobacco products. States piggy-back some of their taxes on federal ones like the income tax and the estate tax. They also levy taxes on similar tax bases like fuel, alcohol and tobacco products. What do you think might happen if the federal government begins to levy a European-style Value Added Tax (VAT)?

Local governments and special taxing districts similarly levy some combination of income, sales and use, and/or property taxes as well as others. In addition to certain somewhat narrow taxes, Kentucky localities currently levy occupational license taxes (often considered by some to be an income tax variant) and property taxes. According to the attorney general, local sales tax would require a constitutional amendment. *See* Ky OAG 13-001 (Jan. 11, 2013).

Different shades of tax reform

Tax systems can be reformed in many ways. These include: eliminating taxes; adding new taxes; expanding or narrowing the tax base, *i.e.,* what is taxed; increasing or decreasing tax rates; centralizing or decentralizing tax administration; updating filing methodologies, *e.g.*, electronic filing, composite reporting; modifying dispute resolution processes; and the list goes on and on.

Revolutionary tax reform - Kentucky Tax Modernization of 2005

The last major reform of the Kentucky state tax system occurred in 2005, House Bill 272 (2005 Ky. Acts, c. 168). The Commonwealth eliminated the corporation license tax, which was imposed on capital, as well as the intangible property tax and replaced them with a gross receipts tax, the Alternative Minimum Calculation (AMC), which is the predecessor to the current Limited Liability Entity Tax (LLET). Tax Modernization brought Kentucky more in line with other states that had likewise eliminated their balance-sheet-type taxes, which are generally viewed as antiquated, and was also in line with the national trend of states enacting gross receipts taxes, which is ironically viewed by some as a somewhat unsophisticated tax when compared with the income tax, for example.

Kentucky also sought to expand the corporation income tax base by closing perceived loopholes and lowering corporate tax rates to align them with individual income tax rates. By imposing the corporation income tax on limited liability pass-through entities, Kentucky decoupled from the generally accepted method of states taxing pass-through entities' income by taxing their owners. Perhaps in recognition of the error, this methodology was abandoned the following year, effective generally for the 2007 tax year. Tax Modernization included other changes, but its focus appeared to be the corporation license tax, the intangibles tax, the corporate rate, the taxation of pass-through entities, and the AMC, now the LLET.

Tax reform in 2013?

Tax reform in Kentucky is somewhat like a cicada brood. One appears every decade or so and makes a lot of noise. Discussions to again reform Kentucky's tax system began a couple of years ago, culminating with the Blue Ribbon Commission on

Tax Reform. The Commission held meetings in Frankfort and across the Bluegrass State in 2012 and issued its recommendations, which can be found on the Commission's Web site at ltgovernor.ky.gov/taxreform. The Commission itself reached a consensus, but only time will tell if there is enough support in the General Assembly for all or even some of the recommendations to be enacted into law. Here, I think it is important to highlight the effort, not the specific recommendations. Without consensus, tax reform will not occur.

Different people have different ideas about what form tax reform should take. Some think that it should focus on making Kentucky more competitive with states, like Indiana and Tennessee. These states make Kentucky's combined marginal state and local income tax rate of more than 8 percent in some localities appear quite oppressive, even New York or California-esque. Others think that tax reform should focus more on raising revenue. These two ideas have little, if any, common ground.

Accordingly, I think the tax climates of 2005 and 2013 are quite different. While many now seem to have forgotten about the corporate license and intangibles taxes (out of sight, out of mind), at the time they were the common enemy of people and businesses. This created what could be referred to as a "perfect storm," and Kentuckians via their elected representatives accepted the bargain required to eliminate the two taxes. In 2013, there is no similar common "tax enemy," though some have attempted to assign this role to the LLET. If there is a common enemy, it would seem to

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be the specter of a broad-based tax on services. Enacting a broad-based tax on services would make Kentucky an outlier among its Sister States. Even the Blue Ribbon Commission steered clear of this tar baby …

Evolutionary tax reform – local tax reform

While major state tax reform is in the spotlight, local occupational license tax reform has been taking place at glacial speed in the background.

It began a decade ago when the Commonwealth enacted House Bill 107 (2003 Ky. Acts, c. 117) requiring localities imposing occupational license taxes to do so in a uniform manner but giving them until Jan. 1, 2006 to make that happen. Although the effective date was postponed, these requirements are now in effect and have been since Jan.1, 2008. *See* 2005 Ky. Acts, c. 153.

Facilitated legislatively by 2012 H.B. 277 (2012 Ky. Acts, c. 70), the secretary of state has made available on her Web site (app.sos.ky.gov/occupationaltax/) all occupational license tax forms, instructions and ordinances. Prior to this, the most accurate and complete list was maintained by KyCPA. Previously, it required almost herculean efforts to acquire this information. Now, it is available at the click of a mouse.

The next phase of the evolution of occupational license taxes is the development of a standard tax form for occupational license tax, again undertaken by the secretary of state. Localities must adopt or accept the uniform form by or before July 2017; note the phase-in, as with the uniformity requirements. *See* KRS 67.766 & 67.767.

What will be next? Central filing? Perhaps a group of localities or a special purpose entity governed by a board composed of locality representatives could coordinate it? Legislation or a confederation of localities could make this happen.

"Well it's nice to have something to look forward to." Ghost in The Matrix Revolutions (2003)

Whether revolutionary or evolutionary, changes in tax laws result in risks and opportunities. Both must be identified. The former managed. And, the latter secured.

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