LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS
200 W. Washington, Suite 301
Indianapolis, IN 46204
(317) 233-0696
http://www.in.gov/legislative

FISCAL IMPACT STATEMENT

LS 7382 **NOTE PREPARED:** Jan 27, 2004
BILL NUMBER: HB 1365 **BILL AMENDED:** Jan 26, 2004

SUBJECT: Various State Tax Matters.

FIRST AUTHOR: Rep. Cochran **BILL STATUS:** CR Adopted - 1st House
FIRST SPONSOR:

FUNDS AFFECTED: X GENERAL **IMPACT:** State
X DEDICATED
FEDERAL

Summary of Legislation: (Amended) This bill makes the following changes to the Sales and Use Tax: (1) Grants a credit against Indiana use tax for sales tax paid in another state for a vehicle, a watercraft, or an aircraft; (2) Makes the furnishing of satellite television service, cable radio service, and satellite radio service a retail transaction; (3) Indicates that a deduction for sales tax paid on a purchase price that becomes uncollectible is not assignable; and (4) Requires certain out-of-state entities to collect sales tax in Indiana.

This bill also requires interest and intangible expenses incurred in certain related member transactions and taken as a deduction for federal income tax purposes to be added back to income for Adjusted Gross Income and Financial Institutions Tax purposes. It makes the following changes to the adjusted gross income tax: (1) Changes the method of calculating the Indiana net operating loss deduction; and (2) Eliminates the carryback of net operating loss deductions.

The bill also repeals the sales tax credit for sales of motor vehicles, trailers, watercraft, and aircraft that are sold in Indiana and titled or registered in another state.

Effective Date: January 1, 2004 (retroactive); March 1, 2004 (retroactive); July 1, 2004.

Explanation of State Expenditures: The Department of State Revenue will incur additional expenses to revise tax forms, instructions, and computer programs to reflect the changes. The Department's current resources should be sufficient to absorb additional costs associated with the implementation of the credit.

Explanation of State Revenues: (Revised) This bill makes several changes to the Sales and Use Tax and the Adjusted Gross Income Tax. The bill is likely to increase revenues from these taxes.

Sales and Use Tax: The bill contains changes to the state's Sales and Use Tax law that would have a positive

impact on state Sales Tax revenue.

Sales and Use Tax Credits: This bill contains two provisions that impact the Sales and Use Tax exemptions and credits associated with the motor vehicle, trailer, watercraft, and aircraft sales. Under current law, sales of motor vehicles, trailers, watercraft, and aircraft that are immediately shipped out of state, delivered for title and used out of state, or those that are not registered for use in Indiana are exempt from the state Sales Tax. This bill removes this exemption and makes the sale of these vehicles subject to the state Sales Tax.

The bill also makes an accompanying change in current law to allow persons who purchase vehicles, watercraft, and aircraft in other states to receive a credit against Indiana's Use Tax for sales taxes paid in another state on the same item. For example, if an Indiana resident purchases a boat in Wisconsin for use in Indiana and the purchaser pays Wisconsin's 5% Sales Tax, this bill would allow the purchaser to receive a credit against Indiana's 6% Use Tax on the taxes paid in Wisconsin. In this example, the purchaser's Indiana Use Tax liability would be limited to the 1% difference between Indiana's and Wisconsin's tax rates.

The changes above are expected to have, on net, a positive impact on state Sales and Use Tax revenue. The full impact of these changes are currently unspecifiable. However, given the large volume of currently exempt vehicle sales in Indiana, the impact of this bill on state Sales Tax revenue is expected to be significant.

Sales Tax on Satellite Television Providers: This provision changes current law to specify that satellite broadcasts of radio or television signals that terminate in Indiana are subject to the state's Sales Tax. (Cable television service is subject to the state's Sales Tax.) Prior to a June 16, 2003, ruling by the state's Tax Court, sales of satellite television service were subject to the state's Sales Tax. The DOR estimates that, absent the language proposed in the bill, the state would lose approximately $12 M each year in Sales Tax revenue.

Assignability of Sales Tax Deductions: This provision limits the Sales Tax deductions for bad debt to retail merchants and specifies that the right to a Sales Tax deduction for bad debt is not assignable from the retail merchant. The DOR estimates that prohibiting the assignment of Sales Tax deductions for bad debt would save approximately $10 M each year. Prior to a January 25, 2002, Tax Court ruling, companies that purchased a retail merchant's debt were not entitled to take a deduction in their Sales Tax liability as a result of bad debt.

Retail Merchants: This bill requires certain entities that are closely related to out-of-state business entities that engage in taxable activities in Indiana to register as retail merchant in Indiana and, when applicable, to collect Indiana's Sales and Use Tax. This provision is expected to have a unspecifiable positive impact on state Sales Tax revenue.

Revenue from the state's 6% Sales Tax is deposited in the Property Tax Replacement Fund (50%), the state General Fund (49.192%), the Public Mass Transportation Fund (0.635%), the Commuter Rail Service Fund (0.14%), and the Industrial Rail Service Fund (0.033%). (Prior to making a retail transaction in Indiana, retailers are required to register with the Department of State Revenue. The fee associated with registration is $25. Fee revenue is deposited in the state General Fund.)

Adjusted Gross Income Tax: The bill contains three changes concerning the Adjusted Gross Income tax of businesses.

Related Member Transactions: The first provision requires that interest and expenses incurred in

certain related member transactions and taken as a federal income tax deduction be added back to Indiana AGI. A common example of the sort of transaction referred to in this provision is the use of a passive investment company (PIC) to transfer taxable income out of Indiana where the income is actually earned and into tax haven states. An Indiana operating company can establish a PIC in a state or other location that does not have a corporate income tax (like Nevada) or that has a special income tax exemption for intangibles (like Delaware) and transfer income ("profits) for various intangible assets such as patents, trademarks, financial assets, etc. to the PIC by having the PIC charge a royalty or other fee to the operating company for the use of a trademark, patent, or for another type of intangible transaction. This reduces the Indiana AGI tax of the operating company. These transactions are further complicated when a PIC loans "profits back to the operating company, and the operating company can then deduct the interest from such loans from Indiana AGI thereby reducing tax liability. Typically, large multi-state retailers engage in these sorts of transactions. The bill requires that such interest and intangible expenses be added back to Indiana AGI. The bill will increase Adjusted Gross Income Tax liability for these firms.

A recent Department of State Revenue audit of companies that have used PICs to transfer income showed that 12 audited companies in tax year 1998 and 11 audited companies in tax year 1999 would have paid an additional $0.9 M and $4.2 M, respectively, in Indiana AGI tax if they would have had to add back income transferred through a PIC. A comprehensive measure of the fiscal impact of the add back of intangible expenses and interest is not available. [This analysis will be updated as more information becomes available.]

Background: The Multistate Tax Commission conducted a study that examined the loss of state corporate tax revenues due to *four* types of tax shelters, one of which is the use of PICs to shelter income from intangibles. The Commission estimates that lost corporate income tax revenues in Indiana ranged from $123 M to $264 M in FY 2001 for all *four* loopholes.

In 1991, the state of Ohio passed legislation to capture income transferred through PICs for state tax purposes. The Ohio Department of Taxation's analysis of the tax returns of the 1500 largest corporations in the state estimates that including PIC income has generated $55 M to $60 M per year in tax revenues for the past two years. Of the 1500 corporations, 100 to 200 have PIC income. The 1500 taxpayers included in the Ohio database account for about 2/3 of the revenue from general corporations (not financial institutions).

Net Operating Loss Deduction: The second provision changes the method of calculating the Indiana net operating loss deduction. Under the bill, Indiana net operating loss is equal to the taxpayer's federal net operating loss adjusted for a variety of modifications. These modifications include adding back state income taxes, property taxes, and charitable contributions and deducting interest on U.S. Government obligations and other modification. Then, the apportionment percentage is applied to determine the Indiana portion of the net operating loss. Net operating loss may be carried forward for up to 20 years after the year in which it is incurred.

The impetus behind this provision of the bill is a court ruling which found that the method used on the tax forms to calculate Indiana net operating loss is different from the method described in the current law. The method of calculating Indiana net operating loss that is prescribed on Indiana tax forms and used by the vast majority of businesses claiming the net operating loss deduction is very similar to the method that is presented in the bill. As a result, the bill should cause little disruption in the way that firms calculate net operating loss and any corresponding carryforward. The statutory change proposed in the bill should have little effect on Adjusted Gross Income Tax revenues.

Net Operating Loss Carryback: The third provision eliminates the carryback of the net operating loss deduction. A carryback allows a firm to deduct current net operating losses from tax liability in prior years.

From a revenue perspective, the problem with carrybacks is that a refund for a prior year's taxes is paid out of the current year's revenues. Eliminating carrybacks will prevent the decrease in current-year Adjusted Gross Income Tax revenue that results from carrybacks and transfer the decrease to future tax years. An estimate of the effects of this provision cannot be determined with current OFMA databases. Federal law currently allows a two year carryback and up to a 20 year carryforward of federal net operating loss.

Explanation of Local Expenditures:

Explanation of Local Revenues:

State Agencies Affected: Department of State Revenue.

Local Agencies Affected:

Information Sources: Tom Conley and Mike Ralston, Department of State Revenue; Bob Lain, State Budget Agency; Multistate Tax Commission, "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, 15 July 2003; Mazerov, Michael. "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States, Center on Budget and Policy Priortities, 23 May 2003; Chris Hall of the Ohio Department of Taxation.

Fiscal Analyst: Dagney Faulk, (317) 232-9592, John Parkey (317) 232-9854.