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:** Feb 5, 2004
BILL NUMBER: HB 1365 **BILL AMENDED:** Feb 4, 2004

SUBJECT: Various State Tax Matters.

FIRST AUTHOR: Rep. Cochran **BILL STATUS:** 2nd Reading - 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 assignable only if the retail merchant that paid the tax assigned the right to the deduction in writing; (4) Requires certain out-of-state entities to collect Sales Tax in Indiana; (5) Provides that gross retail income does not include receipts attributable to delivery charges or installation charges if those charges are separately stated on the invoice.

This bill also requires 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 tax and financial institutions tax purposes and provides certain exceptions to the add-back requirement. It also changes the definition of business income for adjusted gross income tax purposes.

The bill removes the Economic Development for a Growing Economy (EDGE) Board from the administration of the Hoosier Business Investment Tax Credit, provides that the credit is available for hiring new employees, and removes the expiration date for the availability of the credit. This bill also provides that for a pass through entity the proportional amount of the credit to which a partner or shareholder of the pass through entity is entitled is applied against the partner's or shareholder's state tax liability.

It also requires the Department of State Revenue to compile, make public, and publish on the Internet the names and addresses of delinquent taxpayers who have owed more than $1,000 in taxes and penalties for more than 12 months and confers immunity on the Department for publishing the information.

The bill 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: (Amended) January 1, 2004 (retroactive); March 1, 2004 (retroactive); Upon Passage; July 1, 2004.

Explanation of State Expenditures: (Revised) The Department of State Revenue will incur additional expenses to revise tax forms, instructions, and computer programs to reflect the changes. The bill also requires the Department of State Revenue (DOR) to make the determination whether a taxpayer has made a qualified investment or hired the required number of new employees for purposes of the Hoosier Business Investment Tax Credits. The Department's current resources should be sufficient to absorb additional costs associated with the implementation of the changes.

Tax Warrants: The bill requires the DOR to compile a list of taxpayers subject to tax warrants in excess of $1,000 in taxes and penalties that have been outstanding for at least 12 months. The list must include the taxpayer's name, address, and the amount of tax owed. Each month, the Department is required to publish the list on AccessIndiana and make the list available for public inspection. However, prior to including a name on the published list, the Department is required to notify the delinquent taxpayer at least two weeks prior to the list's publication. DOR currently is required to prepare a list of outstanding tax warrants monthly and certify the list to the Bureau of Motor Vehicles. DOR estimates that there are approximately 54,400 warrants that would meet the 12-month specifications of this bill. They estimate that it would cost approximately $43,000 in development costs to generate this list for the Internet with search capabilities. Standard postage costs for the initial monthly notice would be about $20,125. There will be some ongoing costs to replace the report monthly.

Hoosier Business Investment Tax Credit: The bill also relieves the Economic Development for a Growing Economy (EDGE) Board and the Indiana Department of Commerce (IDOC) of administrative demands relating to the Hoosier Business Investment Tax Credit that otherwise would have begun in 2004. Under current statute, the EDGE Board is responsible for administering the tax credit, and the IDOC is required to provide administrative support to the EDGE Board in administering the tax credit.

Explanation of State Revenues: (Revised) This bill makes several changes to the Sales and Use Tax and the Adjusted Gross Income Tax. The net impact of these provision on state revenue is expected to be positive.

Sales and Use Tax: The bill contains changes to the state's Sales and Use Tax law that would impact 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 specifies that Sales Tax deductions for bad debt are only assignable if the retail merchant that paid the tax liability assigns the right to the deduction in writing. The impact on this provision on state Sales Tax revenue is expected to be negligible.

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.

Sales Tax on Delivery and Installation Charges: Upon passage, delivery and installation charges which are separately stated on a retail merchant's invoice are not subject to the state's Sales Tax. The provision is expected to cause a slight reduction in state Sales Tax revenue. (Beginning January 1, 2004, certain delivery and installation charges became subject to the state's Sales Tax insofar as they are included in a retail merchant's gross income from the sale of a taxable good.)

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 two 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 intangible expenses be added back to Indiana AGI. The bill will increase Adjusted Gross Income Tax liability for these firms. Companies that have a location in another country which has a comprehensive income tax treaty with the United States are not required to include payments for intangibles in Indiana Adjusted Gross Income.

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 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.

Hoosier Business Investment Tax Credit: The bill makes several changes to the Hoosier Business Investment Tax Credit that could potentially increase the amount of tax credits that may be claimed under this provision. The precise impact of these changes is indeterminable. The net revenue impact depends on the extent that collections from taxable activities and earnings attributable to the investment in new property or new employees is less than or exceeds the amount of credits claimed by businesses. However, if the investment or new employment would have occurred in the absence of the tax credit, the net impact would be the total credits claimed by businesses. The fiscal impact from these changes could potentially begin as early as the second half of FY 2005 if taxpayers adjust their quarterly estimated payments. The changes to the Hoosier Business Investment Tax Credit expected to have a fiscal impact are as follows.

(1) In addition to the existing tax credit for qualified investment, the bill provides for an additional tax credit for new employees hired by businesses that meet specified hiring requirements. The employment tax credit is equal to 30% of the wages and benefits paid to new employees <u>only</u> during the taxable year in which the

new employees are first employed. To qualify for this credit, a taxpayer must increase employees in the state during the taxable year by at least 10 employees if the taxpayer employed at least 100 employees at the beginning of the taxable year; or at least 10% if the taxpayer employed fewer than 100 employees at the beginning of the taxable year. The credit is nonrefundable and may not be carried back. Unused tax credits may be carried over for up to nine years after the year in which the new employees were hired. The credit amount that the taxpayer may *claim* in the taxable year in which the investment is made is equal to the lesser of: (1) 30% of the qualified investment or (2) the taxpayer's state tax liability growth (see definition of "state tax liability growth below).

(2) The bill also changes the definition of "state tax liability growth. Under current statute, the state tax liability growth is the difference between the taxpayer's state tax liability in a taxable year minus the greater of: (a) the taxpayer's state tax liability in the most recent prior taxable year in which part of a credit was claimed or (b) the taxpayer's tax liability in the taxable year immediately preceding the taxable year in which the investment was made. The bill would eliminate (a) above and base the computation on the difference between the current year tax liability and the tax liability the year prior to the creditable investment. This could potentially allow growing businesses that experience annual increases in tax liability to exhaust credits more quickly than would be the case under current statute.

(3) The bill eliminates the requirements for tax credit review, approval, and oversight by the EDGE Board. This eliminates criteria, including employment and wage criteria, that a taxpayer is required to meet in order to qualify for the investment tax credit. (These criteria and other requirements to qualify for the tax credit are described below under *EDGE Board Requirements*.) Except for the provision prohibiting a taxpayer from claiming the tax credit when jobs are being relocated from one Indiana location to another, the remaining criteria and requirements are eliminated by the bill. Thus, the tax credit for qualified investment could be claimed whether or not it leads to increased employment or employee earnings which the credit is dependent upon under current statute. This could substantially increase the pool of businesses and investment that could qualify for the tax credit.

(4) The bill eliminates the sunset provision in current statute. Under current statute, the investment tax credit can only be awarded for qualified investment during tax years 2004 and 2005.

Revenue from the AGI Tax on corporations, the Financial Institutions Tax, and the Insurance Premiums Tax is distributed to the state General Fund. The revenue from the AGI Tax on individuals is deposited in the state General Fund (86%) and the Property Tax Replacement Fund (14%). Since the changes are effective beginning in tax year 2005 and the EDGE Board approval is no longer required for the tax credits, the fiscal impact could potentially begin during the second half of FY 2004. This would also be contingent on taxpayers adjusting their quarterly estimated payments.

Background: Under current statute, the EDGE Board is authorized to award a taxpayer (an individual, corporation, partnership, or other entity with a tax liability) a nonrefundable tax credit for expenditures on qualified investment that the Board determines will foster job creation and higher wages in Indiana. The tax credit is equal to 30% of the qualified investment. A taxpayer may claim the credit against a taxpayer's Adjusted Gross Income (AGI) Tax, Insurance Premiums Tax, or Financial Institutions Tax liability. If a pass through entity does not have a tax liability, the credit may be claimed by shareholders or partners in proportion to their distributive income from the pass through entity. The tax credit may only be awarded for qualified investment made during tax year 2004 or 2005. The credit is nonrefundable and may not be carried back. Unused tax credits may be carried over for up to nine years after the year in which the investment was made. The credit amount that the taxpayer may *claim* in the taxable year in which the investment is made is equal to the lesser of: (1) 30% of the qualified investment or (2) the taxpayer's state tax liability growth.

Under current statute, the EDGE Board must approve the award of the Hoosier Business Investment Tax Credit to applicant businesses. In order to apply for the tax credit, the taxpayer must propose a project that creates new jobs or increases wage levels in Indiana. Before awarding a tax credit to the applicant the EDGE Board must determine that all of the following exist: (1) the applicant has conducted business in Indiana for at least one year; (2) the project will raise employee earnings; (3) the project is economically sound, will increase employment opportunities, and strengthen the state's economy; (4) the tax credit is a major factor in undertaking the project; (5) the tax credit will have a positive fiscal impact to the state; (6) the taxpayer is not relocating jobs from one Indiana site to another; and (7) the average wage paid by the taxpayer at the project location will be at least 150% of the state minimum wage. The EDGE Board may grant the tax credit only for an amount of qualified investment that is directly related to expanding the workforce in Indiana. Current statute also requires the EDGE Board to enter into an agreement with each tax credit recipient: (1) describing the project; (2) specifying the tax credit; (3) requiring annual reporting of new employment; (4) specifying the minimum wage requirement; (5) requiring the qualified investment property to be maintained in Indiana for the lesser of its useful life or 10 years; and (6) maintaining at least the payroll level at the project location that preceded the qualified investment for the term of the tax credit. Current statute also contains a clawback provision in the event a taxpayer violates the tax credit agreement.

Tax Warrants- Secondary Impact: If the publication of these lists increases the collection of existing tax warrants, additional revenue will be generated. It is unknown how much of the delinquent taxes would be collected sooner due to the publications of these lists. However, it is estimated that after eliminating those warrants which are deemed "exhausted, uncollectible, or under protest, the *minimum* amount of tax liabilities from these warrants, due to the $1,000 threshold, could be at least $200 M.

Explanation of Local Expenditures:

Explanation of Local Revenues:

State Agencies Affected: Department of State Revenue; Indiana Department of Commerce; EDGE Board.

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; Jim Landers, (317)232-9869.