Indiana Manufacturers Association

2014 POLICY GUIDE

State & Local Tax Issues

STATE AND LOCAL TAXATION

The Indiana Manufacturers Association has developed this statement of policy on Indiana tax and fiscal matters. The intent of the policy is to provide a series of goals and objectives for the modification of state and local tax structures.

It is the overall position of IMA that any change to the tax structure which results in additional revenue for state or local government should be considered only after a full review of government spending has occurred and every effort has been made to curtail government spending.

The following policies are based on the IMA's fundamental belief that:

- The tax code, as well as the regulations which implement that code, should be designed to promote economic growth not just raise revenues.
- The tax code/regulations should enhance the state's competitive position relative to the global environment.
- The tax code/regulations should remain compatible with federal tax concepts and definitions.
- The tax code/regulations should provide ease of compliance.
- To the extent possible, the tax code should be comprised of broadly based, low-rate taxes.
- The tax code/regulations and administration thereof should be simple, transparent, neutral, and stable.

OVERALL OBJECTIVES

The primary objective of IMA is to institute a tax structure which:

1) Is less property tax dependent;
2) Positions Indiana to have a more competitive tax climate for economic growth, and;
3) Fosters the protection as well as creation of high paying jobs.

Eliminate the Personal Property Tax Applicable to Production Equipment

Status: Indiana is one of a declining number of states that continues to tax investments in business personal property. Seven states have entirely eliminated personal property taxation, including Iowa, Illinois, and Ohio. Four states have eliminated most personal property taxes, including Michigan (eliminated on small business and eligible manufacturing equipment by 2024).

Problem: For Indiana, taxing production machinery and equipment is a highly counter-productive manner of raising revenues. Indiana's economy is the most manufacturing dependent in the nation. Yet Indiana penalizes further investments in manufacturing machinery and equipment by taxing those investments. The personal property tax is an antiquated tax. While historically it may have been an adequate method of raising revenues, it has no place in today's competitive economic environment. Unfortunately, neither the Legislative Services Agency (LSA) nor the Department of Local Government Finance (DLGF) is able to determine the impact of repealing the personal property tax on industrial machinery and equipment due to the lack of data resulting from the design of the current personal property tax forms.

IMA Position/Solution: The personal property tax as it applies to industrial machinery and equipment should be eliminated. In order to improve the prospects of passage through the legislature, IMA supports improved classification and identification of personal property on state personal property tax forms to enable improved data collection and the determination of an accurate fiscal impact on local governments. Replacement revenues for this tax restructuring, should they be needed, should be collected using current tax collection mechanisms at the local government level and not resemble a re-establishment of the former "property tax replacement credit" method that transfers money from the state treasury to local governments. Moreover, methods of raising replacement revenues should be guided by the principles set forth in this policy document.

Funding Alternatives to Provide Property Tax Relief (Sales Tax)

Status: Indiana's efforts to reduce real property taxes and find funding alternatives for those taxes goes back several decades. The first major effort in this regard was the 1973 Bowen property tax control legislation, which was legislation that raised the state sales tax to reduce local property taxes and placed growth controls on property taxes going forward. More recently, major tax reform legislation was enacted in both 2002 and 2008 for the same purpose. All of those major efforts had at least one component in common--they raised the sales tax to reduce property taxes. In addition, however, the 2008 legislation provides that future increases in local government funding come through the enactment of Local Option Income Taxes (LOIT) and put tax caps (1 percent, 2 percent or 3 percent) on various classes of property.

Problem: Local government funding is still dependent on property taxes, and businesses through real estate and personal property taxes pay a disproportionate share of the property tax burden in Indiana.

IMA Position/Solution: Efforts to reduce property taxes should continue. Additionally, the current overall review of local government efficiency should continue.

If a local option sales and use tax is considered, it must be state administered with a tax base compatible with the state tax base. If expanding the sales tax base to include service transactions is considered, the basic nature of the sales and use tax should not be changed. That is, the tax should be borne by the ultimate consumer of the service; and services utilized in the production of goods must be exempt. Moreover, current provisions limiting the application of the sales tax to goods directly used in the manufacturing process (including utilities) should not be changed. IMA opposes any efforts undertaken in other states to tax business-to-business services.

Funding Alternatives to Provide Property Tax Relief (Local Option Income Taxes)

Status: Indiana currently has three forms of local option income taxes: the County Adjusted Gross Income Tax (CAGIT), the County Option Income Tax (COIT) and the County Economic Development Income Tax (CEDIT). Each of these taxes was enacted at different times with tax proceeds dedicated to specific purposes. Legislation enacted in 2008 added a fourth component to LOITs--a series of additional county-based income taxes that can be used to either cap property taxes, reduce property taxes and/or provide additional revenues for public safety. Tax rates on each of these four LOITs are capped.

Problem: Local government funding is still dependent on property taxes, and businesses pay a disproportionate share of the property tax burden in Indiana through real estate taxes and the personal property tax.

IMA Position/Solution: IMA supports the concept of Indiana becoming less property tax dependent. As a result, IMA supports local income tax options that offset property taxes. Such proposals, however, need to be administratively workable and compatible with IMA's overall tax objectives. Moreover, it should be recognized that the majority of small businesses pay taxes through the individual income tax. Uncapped or excessive local option income taxes may have an adverse impact on local job growth as these businesses are further taxed. IMA opposes applying LOITs to C corporations as administratively unworkable and as a tax increase on job creation and investment that will increase the cost of doing business in Indiana. Moreover, local spending practices should be reviewed prior to any additional tax mechanisms being imposed.

Support Conformity with Internal Revenue Code 199
(Domestic Production Activities Deduction)

Status: IRC 199 was signed into law by President George W. Bush as part of the American Jobs Creation Act of 2004. The deduction was designed to protect U.S. jobs and replace the Extraterritorial Income (ETI) exclusion, which was a tax incentive to encourage exports by U.S. manufacturers that was ruled illegal by the World Trade Organization (WTO) in 2002. The IRC allows a taxpayer to claim a nine percent deduction from qualified production activities income (QPAI). To calculate QPAI, the taxpayer must generate domestic production gross receipts (DPGR) from any of the following activities within the United States:

- Manufacture of tangible personal property
- Production of recordings and certain films
- Production of electricity, natural gas, or water
- Construction, engineering, and architectural services

Problem: In 2005, the General Assembly "de-coupled" state tax law from IRC 199 before the deduction ever went into effect requiring Hoosier manufacturers to "add back" to state taxable income the IRC 199 deduction amount claimed on the federal tax return. Indiana, in addition to 21 other states, disallow the deduction; but 25 states permit it to some extent, including Michigan, Illinois, Kentucky, Ohio, Pennsylvania, Iowa, and Missouri. It was estimated in early 2013 by the left-leaning Center on Budget and Policy Priorities (CBPP) that a full "re-coupling" with IRC 199 would cost Indiana approximately $41 million.

IMA Position/Solution: IMA supports conformity with IRC 199 for three reasons:

1. Manufacturing is critical to Indiana's economy. Over 16 percent of total employment in Indiana is engaged in manufacturing, the highest percentage in the United States. A strong manufacturing sector creates significant benefits for society, including good-paying jobs, investment in research and development, essential materials for our national defense, and high-value exports.

2. Neighboring states Michigan, Illinois, Kentucky, and Ohio allow manufacturers to claim at least a portion of the deduction on their state tax returns placing them in a more competitive advantage with the manufacturing sector than Indiana.

3. The State of Indiana has a nearly $2 billion surplus, so affordability is not an issue as it was in 2005 when the decision to not conform to IRC 199 was made. When one considers IRC 199 will likely be used by manufacturers to hire more Hoosiers in high-paying jobs and lead

to greater spending on new equipment and machinery, conformity with IRC 199 is a good investment in the Hoosier manufacturing sector.

Lastly, the IRC 199 deduction amount should be designed to incentivize Hoosier-based manufacturers. Therefore, the Indiana 199 deduction amount should be based upon a similar concept to the Indiana R&D credit amount calculation that considers Indiana-based activity and does not bear a relationship to the sales factor apportionment.

Support Repeal of the Throwback Rule on Exports

Status: Since 2011, Indiana has been a single sales factor state. Indiana uses a destination test as the general rule for sourcing receipts in computing the sales factor for sales of tangible personal property. An Indiana manufacturer's sales are included in the numerator of the sales factor if:

1. The property sold is delivered or shipped to Indiana;
2. The property is sold to the U.S. government and the property is shipped from Indiana; or
3. The property sold is delivered or shipped from Indiana to a destination outside of Indiana and the seller is not subject to tax in the destination state or country. IC 6-3-2-2(e); 45 IAC 3.1-1-53.

The sales described in (3) above are assigned to Indiana under the "throwback rule." The throwback rule applies when a seller is not taxable in the destination state or country.

Problem: The throwback rule focuses on whether the seller is taxable in the destination state or country. Currently, sales to a buyer outside the U.S. are used in apportioning income of the Hoosier manufacturer/seller to Indiana when the seller is not subject to being taxed by the jurisdiction of the buyer. This is detrimental to Hoosier manufacturers who export a large amount of goods overseas to countries that do not tax those sales. Any proposal to repeal the "throwback rule" on exports will likely reduce corporate tax collections to Indiana, but the fiscal impact has been found "indeterminable" by Legislative Services Agency (LSA).

IMA Position/Solution: IMA supports legislation that will repeal the "throwback rule" with respect to sales made to buyers outside the U.S. in countries that do not tax such sales income. The "throwback rule" does not fairly measure a corporation's business activities in Indiana. A repeal of the "throwback rule" on exports will stimulate export sales by Hoosier manufacturers.

Encourage Investments in Production Equipment (Investment Tax Credits)

Status: Currently, a number of states allow corporate taxpayers a credit for a portion of investments in production equipment. Most of these state provisions provide far better investment incentive than does Indiana's Hoosier Business Investment (HBI) tax credit. The HBI Tax Credit provides incentives to businesses to:

1. Create new jobs or increase wage levels in Indiana; or

2. Substantially enhance the logistics industry by creating new jobs, preserving existing jobs that otherwise would be lost, increasing wages in Indiana, or improving the overall Indiana economy, in the case of a logistics investment being claimed by the applicant.

The non-refundable corporate income tax credit is calculated as a percentage of the eligible capital or logistics investment to support the project. The total amount of a tax credit claimed for a taxable year is a percentage determined by the Indiana Economic Development Corporation (IEDC) not to exceed:

1. 10 percent of the amount of a qualified investment made by the business in Indiana during that taxable year for non-logistics investments; and

2. 25 percent of the amount of a qualified investment made by the business in Indiana during that taxable year, if the qualified investment is a logistics investment.

Problem: Indiana's economy is the most manufacturing dependent in the nation. The vitality of that economy is dependent on Indiana's industrial sector making the necessary investments in production equipment that enhance productivity and thereby allow Indiana's industrial sector to compete in both domestic as well as foreign markets. Indiana is competing against other states, some of which provide investment tax credits, for business investment dollars. Yet, Indiana's current corporate tax structure hinders industry's ability to invest in job-creating and job-retention activities.

IMA Position/Solution: IMA supports making the HBI Tax Credit refundable similar to the Economic Development for a Growing Economy (EDGE) Tax Credit. EDGE Tax Credit is a refundable corporate income tax credit that provides incentive to businesses to support jobs creation, capital investment, and to improve the standard of living for Indiana residents. States such as New York and Iowa offer refundable investment tax credits for qualified investments under certain circumstances, such as for new businesses. Indiana should offer the same.

IMA supports amending the HBI Tax Credit criterion to allow IEDC to consider the preservation of existing jobs that otherwise would be lost for non-logistics investments. Preservation of existing jobs is a criterion to be considered for qualified logistics investments under the HBI Tax Credit; as a result, this criterion should be included for non-logistics investments, as well.

Support Cyclical Reassessments and Annual Adjustments

Status: In 2006, a procedure called "trending" or "annual adjustment" was utilized in Indiana for the first time to ensure assessed values of real property reflected the property's market value-in-use. Trending involves researching sales of properties in an area over the previous year and using that information to update the values of comparable properties. In 2012, Indiana marked the conclusion of the latest statewide reassessment of property, the first since 2002. The reassessment was performed over a 20-month period from July 2010 to March 1, 2012. Local assessors of every county were required to conduct a physical inspection of each property to verify the county's property record information and gather cost, sales, and income data to determine assessed values. Trending decreases drastic changes to property values between reassessments by updating values on an annual basis. Therefore, while values have surged in past reassessments, the overall net assessed value statewide actually decreased 1.1 percent after the 2012 reassessment compared to 2011.

Starting in 2014, Indiana will move to a "Cyclical Reassessment" process whereby properties will be physically inspected over a four-year timeframe (25 percent of parcels inspected each year) instead of the current 20-month timeframe. It is expected that by spreading the assessment work over a longer period of time, there will be greater accuracy of the underlying parcel characteristics. Trending will continue during the cyclical reassessment process.

Problem: Historically, the differing assessment cycles for real estate and personal property resulted in gradual shifts of tax burden from real estate to personal property. The swing resulted from the upward pressure of inflation affecting personal property assessments each year, while real estate remained static until the next reassessment.

IMA Position/Solution: IMA supports maintaining the current annual adjustment, or "trending," process each year to ensure real property reflects market value-in-use. Additionally, IMA supports the enactment of the cyclical reassessment process to ensure annual physical inspections of at least 25 percent of the real property in a county, which should result in more accurate valuation through frequent data collection and the proper recordation of property characteristics.

Support Application of USPAP Ethics and Competency Standards to Local Assessors and Third-Party Vendors

Status: Indiana statute (IC 25-34.1-3-8) exempts local assessors and third-party "professional appraiser" vendors from state real estate appraiser licensure requirements along with all Uniform Standards of Professional Appraisal Practice (USPAP) guidelines, which promote and ensure a high level of trust in appraisal practice. However, 50 IAC 27-1-3 requires USPAP compliance when local assessors complete the annual adjustment, or "trending," assessments; but the cyclical reassessment rule does not address USPAP compliance.

Problem: There is confusion about the application of USPAP Ethics and Competency standards to local assessors and their third-party vendors. The inherent by-product of the current statutory confusion over USPAP application includes permitting role conflicts with third-party vendors who are simultaneously acting as appraisers and advocates, allowing appraisal reviews by unqualified parties, and perpetuating assessment quality challenges for more complex property assessments.

IMA Position/Solution: IMA supports improving public trust in the Indiana assessment system and safeguarding Indiana taxpayer interests by reforming state licensure laws to require local assessors and their third-party vendors to comply with current USPAP Ethics and Competency standards relative to their future annual trending and cyclical reassessment responsibilities. From a practical standpoint, implementing the Ethics USPAP standard would require separate, independent "professional appraiser" firms to handle county mass appraisal and advocacy functions. To satisfy the USPAP Competency standard, involving qualified certified appraisers at the county level assessment process, including appraisal reviews, would help to improve overall assessment quality for the more complex property types.

Property Assessment Classification/Tax Caps

Status: The Indiana Constitution provides that all property be assessed on a uniform and equal basis. The Indiana Constitution also provides for various "tax caps," which vary depending on the type of property. The Indiana property tax system is not technically a "classified" property tax system in that all properties are assessed under the same principals and taxed at the same tax rate. For business properties, however, tax bills cannot exceed 3 percent of gross assessed value while residential properties are tax capped at 1 percent of gross assessed value. In addition, homestead properties receive substantial deductions from assessed value that do not apply to other types of properties, such as the $45,000 homestead deduction and an additional 25 percent or 35 percent supplemental homestead deduction. The overall effect of this system over time is to shift property taxes from lower tax capped properties (homesteads) to higher tax capped properties (commercial and industrial real and personal property).

Problem: Hoosier businesses pay a disproportionate share of the property tax burden in Indiana. For example, after the 2008 property tax reform legislation that included the increased homestead deductions and implementation of the "1-2-3" tax caps, a 2011 study by the Legislative Services Agency (LSA) found that while net taxes across all property types decreased 10.3 percent from 2007 to 2011, business real and personal property taxes *increased* 6.3 percent. Additionally, a November 2012 study by the Tax Foundation found that although nationwide, state and local governments collected 44 percent of property tax revenue from residential property and 56 percent from non-residential property (mostly commercial and industrial), in Indiana, the share of property taxes collected from non-residential property was 71 percent versus 29 percent from residential property. This ratio is even more startling when one considers that 63 percent of the total gross assessed value of real property in Indiana is classified as "residential" compared to 5 percent "industrial" and 17 percent "commercial." Finally, a review of effective property tax rate studies of 2007 through 2010 from the Department of Local Government Finance indicates that Hoosier businesses pay nearly four times more in real and personal property taxes than homesteads.

IMA Position/Solution: IMA supports a review of and serious consideration by the Indiana General Assembly to reduce the large homestead and supplemental homestead deductions offered to homeowners in order to reduce the disproportionate share of the property tax burden currently paid by business. Indiana must assess property based upon principals of equity and uniformity. In addition, property tax rates should apply uniformly to all properties. Tax caps (i.e. not allowing taxes to exceed a certain amount) are effective taxpayer protections and therefore are acceptable, even if the caps vary by property type. However, the reality of the situation is that with Indiana residential properties enjoying substantial assessed value deductions and a 1 percent tax cap, the property tax burden has swung too far against business real and personal property taxes.

Tax Increment Financing (TIF)

Status: Tax Increment Financing (TIF) is a method of funding local redevelopment projects by capturing the incremental increase in property tax revenues, which occurs when redevelopment increases property values. In areas designated as TIF districts, local taxing units continue to receive property taxes levied on assessed value before redevelopment; additional revenues generated by rising property values are allocated to redevelopment costs until those costs are repaid. TIF has been in effect in Indiana since 1975.

Problem: While the arguments for and against TIF mirror the arguments for and against tax abatement, the nature of TIF creates additional issues. For example, bonding is ordinarily a component of TIF creating type of bonds, repayment term as well as additions to debt concerns. Moreover, TIF differs from tax abatement in that specific taxpayers are financing infrastructure improvements for their own benefit whereas the benefit/detriment of tax abatement is on a community wide basis. The result of these concerns is to surround TIF with continual efforts to diminish the use of TIF and even to eliminate TIF entirely.

IMA Position/Solution: While it is appropriate for the legislature to continue to review the use of TIF and to make improvements where needed, Indiana needs to maintain TIF as a permanent part of the state's redevelopment options. More than 30 other states utilize this economic development tool. For Indiana to diminish or eliminate TIF would put the state at a competitive disadvantage.

Tax Abatement

Status: Tax abatement is intended to encourage new capital investment by providing deductions from increases in the value of property for property tax purposes. Legislation enacted in 2011 allowed counties greater flexibility to develop county-specific abatement schedules.

Problem: The use of tax abatements to encourage investment is controversial. Advocates argue that the program generates jobs, stimulates the local economy and increases the tax base of the community. Critics contend that it has little effect upon business location/expansion decisions and narrows the tax base thereby increasing tax rates on other taxpayers. They consider tax abatement to be "corporate welfare;" and in their view, it subsidizes investments that would have been made without tax abatement.

IMA Position/Solution: Tax abatement is a vital economic development tool. More than 30 other states utilize tax abatement. For Indiana to diminish or repeal tax abatement would put the state at a competitive disadvantage.

Tax Credit for Use of Recycled Waste

Status: Present law provides a limited number of credits against a corporation's state income tax liability that are primarily to encourage investment in certain specific areas. Research and development activities and the treatment of drug and alcohol abuse by employees are two examples of these credits. There is no such income tax incentive for corporations to recycle waste or use recycled waste products.

Problem: The issue of solid waste disposal and landfill capacity in Indiana deserves immediate attention. Much of the waste, such as metal and paper products, can be recycled.

IMA Position/Solution: Indiana should encourage the use of recycled waste to produce a finished product by providing a tax credit against the corporate income tax for manufacturers who either purchase recyclable waste or invest in operational changes necessary to allow the reuse of waste or by-products of their own process.

State Surplus Revenues/State Spending Levels

Status: In 2010, Indiana enacted legislation to provide that whenever a state budget surplus exceeds a certain level -- now 12.5 percent of general revenue appropriations in a state fiscal year -- half of that excess will automatically be refunded to taxpayers in the form of an automatic taxpayer refund (ATR). The other half of the excess will be used to pay down any outstanding state pension debt. However, the recent state biennial budget requires that in 2013, 100 percent of the excess reserves will be directed toward the pension stabilization fund. For 2014 and thereafter, 50 percent of any excess reserves is to be directed to the pension stabilization fund and 50 percent is to be used for the purposes of providing the ATR.

Problem: Indiana has, over the decades, struggled with the question of what to do with large budget surpluses. Defining the level of adequate state budget reserves has been part of the issue. Additionally, conflicts between additional spending and reducing taxes develop. At times, the state has dedicated surplus amounts to specific debt reductions; and at times, the state has developed one-time mechanisms to return some monies to taxpayers. The 2010 provision is the first time Indiana has established an ongoing surplus reduction/taxpayer refund provision.

IMA Position/Solution: The Indiana Manufacturers Association supports the automatic taxpayer refund (ATR) provision first enacted in 2010, and the decision in the recent biennial state budget to direct 100 percent of the excess reserves toward the pension stabilization fund in 2013. IMA believes that maintaining an excessive level of surplus goes beyond the role of wise fiscal stewardship and that a portion of surplus revenues should be returned to the private sector, so that those monies can be reinvested in further wealth-creating activities. In returning surplus revenues to the private sector, IMA recommends the following:

- While a budget surplus may be a cumulative amount based upon several consecutive years of economic growth, recessions are a natural and reoccurring component of the economic cycle. As a result, maintaining a sufficient reserve to protect against the need for tax increases or Draconian budget cuts during economic downturns should be of primary importance.

- The state should not commit itself to ongoing spending programs that result in further building the state's expenditure base. Government spending programs immediately become perceived as entitlements. Once initiated, they are almost impossible to curtail.

- Any surplus reduction program should be based upon fostering economic growth. Short-term political considerations should be avoided. Surplus revenues should be focused upon areas in the private sector where the best current research indicates the greatest value in terms of economic growth.

- Recognition that the state continues to have an unconscionable level of unfunded pension obligations must govern the options chosen. Unfunded pension liabilities are, in effect, tax burdens placed upon future generations. Some allocation of the state's surplus balances should be set aside in a dedicated fund to reduce the unfunded liabilities of the pension stabilization fund and local public safety pensions.

Under current government accounting practices, taxpayers are unable to readily ascertain the financial position of the state. To foster better taxpayer understanding, as well as to add a greater consistency to the presentation of state financial data, standard accounting practices similar to those that exist in the private sector should be developed and strictly adhered to by all governmental bodies.

IMA further recommends that effective prohibitions against excessive increases in state spending be implemented. A constitutional amendment limiting state spending increases to some measure that incorporates both economic and population growth would be advisable. Any spending limitation, however, should not be so inflexible that it cannot be overridden by an affirmative vote of a substantial majority of the legislature.