LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

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FISCAL IMPACT STATEMENT

LS 7313
BILL NUMBER: HB 1374

DATE PREPARED: Feb 29, 2000
BILL AMENDED: Feb 28, 2000

SUBJECT: Various state and local taxes.

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FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: (Amended)This bill makes various changes concerning the Gross Income Tax, the Sales and Use Tax, the Adjusted Gross Income Tax, federal tax refunds for Indiana income taxes owed, ordinances regarding local taxes, and Roth IRAs and educational IRAs. It updates the references to the Internal Revenue Code for 2000, provides that oil inspection fees collected by licensed gasoline distributors are not gross income, and removes vehicle identification information from the income tax return. The bill also provides that the state welfare allocations calculated as part of the Financial Institutions Tax distributions and the Motor Vehicle Excise Tax distributions are based on amounts levied by counties for the county welfare fund and the county welfare administration fund, rather than the amounts appropriated from those funds.

The bill modifies the Research Expense Tax Credit by repealing the apportionment limit for taxable years beginning after December 31, 2001. (For a taxpayer with income apportioned to Indiana, this provision currently limits the credit to the lesser of the taxpayer's Indiana qualified research expenses or its apportioned research expenses for the year. This bill would provide that a taxpayer's credit is based solely on the taxpayer's Indiana qualified research expenses.)

This bill reduces the Insurance Premium Tax rate from 2% to 1.3% over a five year phase-in period that begins in 2003. It provides that certain insurance companies domiciled in Indiana must maintain in Indiana: (1) a physical presence that provides an economic benefit to Indiana; and (2) company records.

The bill also repeals the Investment Income Tax Credit and the Prison Investment Income Tax Credit and corrects internal references.

Effective Date: (Amended) Upon passage; January 1, 2000 (retroactive); July 1, 2000; January 1, 2001; January 1, 2002; July 1, 2002.

Explanation of State Expenditures: (Revised) *Vehicle identification information:* This bill deletes the requirement that the Department of State Revenue (DOR) obtain vehicle identification information from taxpayers on the tax return.

Sales Tax Remittance & Reports: The requirement that remitters of sales and use tax pay monthly, but only file reports on a quarterly basis is designed to create administrative savings for the Department and taxpayers.

Insurance Premium Tax: The Department of State Revenue and the Department of Insurance will incur some administrative expenses associated with changing tax forms, instructions, and computer programming.

Explanation of State Revenues: (Revised) *Internal Revenue Code Update:* A number of federal tax provisions were included H.R. 1180 - 1999 would affect the calculation of Indiana Adjusted Gross Income. These provisions will have minimal impact on revenue collections beginning in FY 2000 and beyond. Some of these provisions include the following:

- a two-year extension of the exception from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived from the active conduct of banking, finance or insurance;
- exclusion for employer-provided educational assistance through December 31, 2001;
- extends the duty-free treatment under the Generalized System of Preferences (GSP);
- extends the expensing of environmental remediation expenditures;
- limits long term capital gain treatment to certain income in transactions involving pass-through entities;
- prohibits the use of the installment method by accrual method taxpayers;
- numerous changes relating to the treatment of real estate investment trusts (REITS).

County Remittance: This bill allows county treasurers to remit gross income tax receipts from the sale or transfer of an interest in real estate to the Department of State Revenue on the 20th day of the month following the end of a quarterly period. Current law requires the remittance to be on the 15th day of the month. This will result in a minimal loss of interest earnings from the five-day delay of receiving these tax receipts but it will bring the remittance dates in conformity with other tax filing dates.

Use Tax exemption: The bill clarifies that the use tax exemption for tangible personal property processed in Indiana by commercial printers and transported out of Indiana for sole use outside of Indiana applies to property that is delivered into Indiana from sources within or outside the state. Any impact would be negligible.

Definition of dependent: For purposes of the employee medical care savings account plans, the definition of dependent is changed to be consistent with the Internal Revenue Code. This change expands the definition except for the exclusion of mentally or physically incapacitated children over the age of 18.

Oil Inspection Fees: The bill provides that oil inspection fees collected by licensed gasoline distributors are not considered gross income for purposes of calculating a taxpayer's tax liability. According to the Department of State Revenue, this exemption would result in a $60,000 reduction in Gross Income Tax revenue. This revenue is deposited in the General Fund.

Repealed Tax Credits: This bill also repeals the Investment Income Tax Credit and the Prison Investment Income Tax Credit. According to the Department of State Revenue, no one has utilized these credits so there will be no impact resulting from their repeal.

Calculations of Welfare Allocation: The provision which changes the calculation of state welfare allocations to be based on county levies for the county welfare fund and the county welfare administration fund, rather than the amounts appropriated from those funds, clarifies how these distributions are to be made and corresponds to the current practice of other local distributions.

Research Expense Credit: The elimination of the apportionment factor could increase the amount of Research Expense Credits taken by an additional $5.2 M annually beginning in FY 2003. This modification would mean that the credit is based on the taxpayer's Indiana qualified research expenses rather than the lesser of its Indiana qualified research expenses or its apportioned research expenses for the tax year beginning January 1, 2002. Currently only businesses that do not have income apportioned to the state for a taxable year may calculate their credit based on only Indiana research expenses.

It is unknown how many Indiana businesses would be affected by this change. This change would not reduce the amount of credit that is currently taken by any particular taxpayer. This change would benefit Indiana domiciled companies that conduct a significant amount of their research in Indiana, but have apportionment factors for income earned in Indiana that is less than the percentage of their overall research expenses in the state. Elimination of the apportionment factor will allow all companies to compute their tax credit based on the amount of research conducted in the state.

With additional incentives created for research and development activity based in the state of Indiana, the revenue loss from this credit could increase by an indeterminable amount. The credit provides $50,000 for each $1 M in new research expenses.

Increase expenditures on research activities could also generate additional Adjusted Gross Income and Sales Tax revenue if these expenses are used to hire additional employees or purchase related equipment. The research expense tax credit affects revenue collections deposited in the General Fund and Property Tax Relief Fund. Over the past five years, the current Research Expense Credit has ranged from $7 M to $15 M. In FY 96 and FY 97, approximately $9.2 M and $15.3 M of tax credits were claimed respectively.

Insurance Premium Tax: This bill phases down the rate of the Insurance Premium Tax over five years beginning in CY 2003. The schedule of the reduction is as follows:

Calendar Year(s)	Tax Rate
2000-2002	2.0%
2003	1.9%
2004	1.8%
2005	1.7%
2006	1.5%
2007 and thereafter	1.3%

The Insurance Premium Tax is assessed on gross premiums received on policies covering risks in the state of Indiana. The tax base is comprised of premiums written or renewed in the past year minus deductions of reinsurance premiums, dividends paid to resident insureds, and premiums returned. The tax rate is currently 2.0% of these net premiums. The tax is paid by all insurance companies doing business in Indiana, however, companies domiciled in Indiana may elect to pay the Corporate Gross Income Tax in lieu of the Premium Tax (domestic firms also must pay the Supplemental Net Income Tax, or SNIT). Revenue from the Premium Tax is deposited in the state General Fund.

Reducing the Premium Tax rate could affect revenues from the Insurance Premium Tax, Gross Income Tax, and SNIT as follows:

Premium Tax: A reduction in the Insurance Premium Tax rate may affect domestic insurance companies differently than out-of-state entities:

(1) *Effect on domestic companies:* Decreasing the Insurance Premium Tax rate by 35% would not simply reduce the amount of tax due on premiums written in Indiana by the same proportion. This is partly because domestic companies may elect to pay the Gross Income Tax in lieu of the Premium Tax. In fact, of the more than 130 insurance companies domiciled in Indiana, only 44 elected to pay the Insurance Premium Tax in 1998. Only about $3,650,000 in premium taxes were paid by Indiana domiciled insurance companies in 1998. If the Premium Tax rate is lowered, more companies may find it advantageous to pay the Premium Tax, simultaneously reducing Gross Income Tax revenue.

(2) *Effect on insurance companies not domiciled in Indiana:* The impact on out-of-state insurance companies varies with each state of domicile. This is due to Indiana's retaliatory tax provision, which provides that premiums written in Indiana by a company not domiciled in Indiana are taxed at either Indiana's rate or the rate in that company's home state, whichever is higher. The varying effects of the retaliatory provision are outlined in the following paragraphs:

(a) *Rates of 2.0% and above:* Premium Tax revenue collected from companies domiciled in states with a rate of 2.0% or higher would not change, no matter how low Indiana's rate was set. Because of the retaliatory provision, Indiana would collect at the higher of the two rates, which would still be at least 2.0%.

(b) *Rates between 2.0% and 1.3*%: Under this bill, Indiana will lose some revenue from companies in states where the Premium Tax rate is below 2.0% but above 1.3%. Connecticut, for example, has a rate of 1.75%. Under current law, the tax on premiums written by Connecticut companies in Indiana would be assessed at 2.0%. After a change in Indiana's rate to 1.3%, taxes on Connecticut premiums would be collected at 1.75%, the higher of the two rates. The retaliatory provision mitigates the potential loss with companies from states with premium tax rates between 2.0% and 1.3%.

(c) *Rates below 1.3%:* For companies domiciled in states with rates below 1.3%, the effect would be to reduce taxes paid in Indiana by 35%. The highest rate that would be applied would now be 1.3%, not 2.0%.

Although the retaliatory provision mitigates the potential loss, Premium Tax revenue from out-of-state companies would likely decrease whenever the rate is lowered. The net effect depends greatly on the number of domestic companies that switch to pay the Premium Tax rather than the Gross Income Tax. The impact of the proposed rate change on Insurance Premium Tax revenue was estimated using a model that included retaliatory tax effects. Three important assumptions made in this analysis are outlined in the following paragraphs.

Based on recently proposed or enacted legislation, changes and phase-downs in premium tax rates of neighboring states were incorporated in the model. Rates were lowered to 1.4% in Ohio, 1.5% in Kentucky; and 1.5% in Illinois (other various reductions in Alabama, Colorado, Tennessee, and Washington DC were also applied). All other states were assumed to maintain the same rates imposed in 1998.

The majority of Indiana domestic insurance companies do not pay the Insurance Premium Tax. If the rate was lowered, more companies may elect to pay this tax in lieu of the Gross Income Tax. It is not known if a 1.3% rate would be sufficient for all firms to make this transition. However, it is believed that most companies would continue to pay the Gross Income Tax despite the decrease in the Premium Tax rate. For the purposes of this analysis, it was assumed that no companies would switch from one tax to the other.

After considering past premium tax collections and their cyclical nature, premiums written in Indiana were estimated to grow by 2.5% annually.

Based on the assumptions stated above, the following table illustrates the impact of the phase-down of the Insurance Premium Tax. The revenue loss reported below reflects the reduction in revenue due to the reduced rate after estimating growth in premium revenue collections at the current 2% Premium Tax rate. FY 2003 represents only 6 months revenue impact on collections assuming that insurance companies adjust their first two quarterly payments in CY 2003.

Fiscal Year	Revenue Impact
2003	($2.6 M)
2004	($7.9 M)
2005	($13.2 M)
2006	($20.3 M)
2007	($27.1 M)
2008	($29.7 M)

In FY 2008, the phased-down rate would result in an estimated loss in Premium Tax revenue of about $29.7 M. Even if the rate remains at 1.3% after 2007, the negative impact may gradually increase if premiums continue to grow.

If the same domestic companies currently paying the Premium Tax are taxed at 1.3%, these firms would see their Indiana Premium Tax liability reduced by about $1.8 M in FY 2008 due to the rate reduction. The remaining $27.9 M represents both tax savings for out-of-state insurance companies and a loss of retaliatory tax revenue for Indiana. It should be noted that reducing the Premium Tax rate will reduce retaliatory payments made by domestic companies to other states, regardless of which tax these firms currently elect to pay within Indiana.

As stated above, this model includes proposed or enacted changes in other states. Because some states that previously had premium tax rates (or effective premium tax rates) above 2.0% and are instituting reductions, Indiana will lose some revenue unless the present Premium Tax rate was increased. If Indiana's rate remains at 2.0%, the already proposed or enacted reductions in Alabama, Colorado, Louisiana, Ohio, and Washington DC will generate an annual loss of more than $3.2 M in retaliatory tax revenues to Indiana beginning in FY

2001. To account for this effect, this amount has already been subtracted from the impacts shown in the table above.

Gross Income Tax: The Gross Income Tax is normally assessed on the total gross receipts of a corporation's transactions in Indiana. However, not all of the gross receipts of an insurance company are taxed under the Gross Income Tax. The tax rate is 1.2%, and revenue from this tax is deposited into the state General Fund.

Only 44 insurance companies domiciled in Indiana currently elect to pay the Insurance Premium Tax. The remaining companies paid approximately $30 M in Gross Income taxes in 1998. Because the projections in the table above assume that these companies will continue to pay the Gross Income Tax even after the Premium Tax changes, Gross Income Tax revenue would be unaffected. However, as the premium tax is reduced, more companies may find it advantageous to pay the Premium Tax. If all companies switched to the Premium Tax, annual Gross Income Tax revenue would decrease by at least $30 M (based on 1998 payments). Some of the potential loss in Gross Income Tax revenue would be offset by a corresponding increase in Premium Tax revenue.

Supplemental Net Income Tax: Supplemental Net Income Tax (SNIT) liability is specially calculated for domestic insurance companies. The tax base is the federal taxable income of the company adjusted by:

(Step 1) Multiplying the federal taxable income by the ratio of Premium Tax receipts from policies insuring persons or property in Indiana to total premiums receipts; and

(Step 2) subtracting the company's Gross Income Tax liability or the gross Premium Tax liability, depending on which one the company has elected to pay.

The adjusted tax base as calculated above would then be multiplied by the SNIT rate of 4.5% to determine tax liability. SNIT revenue is deposited in the state General Fund.

If an insurance company switched from paying the Premium Tax or Gross Income Tax to the other because its taxes burden would be less, the amount subtracted in Step 2 would be smaller, resulting in greater SNIT liability. The DOR estimates that between $5 M and $8 M in SNIT is paid annually by domestic life and property and casualty insurance companies. This amount appears to vary annually due to the effects of filing consolidated returns and tax credits claimed by these companies.

If Indiana domiciled insurance companies continue to pay the same tax (either the Gross Income Tax or the Insurance Premium Tax) as they elected to pay in 1998, a reduction in the Premium Tax rate to 1.3% would generate $1.8 M in tax savings for the Premium Tax payers (as mentioned above) in FY 2008 when the reduction is fully phased-in. These companies would not be able to deduct this net gain from their adjusted tax base (see Step 2 above), resulting in an annual state increase of $80,000 in SNIT revenue ($1.8 M x 4.5%). Gross Income Tax payers' SNIT liability would be unaffected under this scenario.

Net impact from Insurance Premium Tax rate reduction: The table below summarizes the estimated net impact in FY 2008 for insurance premiums upon full implementation of the Insurance Premium Tax rate reduction from 2.0% to 1.3%:

Impact in FY 2008 (fully phased-in reduction)	Revenue Impact
Premium Tax impact	($29,700,000)
Gross Income Tax impact	$0
SNIT impact	$80,000
NET IMPACT	($29,620,000)

Based on the previously stated assumptions, the projected impact of this bill would be a $29.6 M decrease in state General Fund revenues by the final phase-out year. It is important to note that reducing the Premium Tax will reduce the cost of doing business in other states for Indiana’s domestic insurance companies. The total benefit to these companies as a result of this reduction is not currently known, but is expected to be significant. If these companies remain and prosper in Indiana or if new business is attracted to the state, corporate and personal income tax revenues could increase.

Domiciled Companies: This bill also provides that for a company to become domiciled in Indiana after June 30, 2000, it must maintain a physical presence and an economic benefit to the state. The company must also have complete records regarding assets and transactions which are available to the Department of Insurance either physically or electronically. If the Commissioner of the Department determines that a company does not meet these requirements, it may require the firm to transfer its domicile to another state. The Commissioner may also allow the company to retain domicile in Indiana but impose additional administrative fees to compensate for the cost of regulating the domestic company as a foreign company.

Additional fee revenue would be deposited in the Department of Insurance Fund. However, it is expected that there would be few cases in which the Department would impose these fees.

Explanation of Local Expenditures:

Explanation of Local Revenues: (Revised) *Local Option Taxes:* The bill specifies that if a local unit of government adopts a local option tax, the ordinance must be adopted after January 1 and before April 1 of a year and takes affect on July 1 of the year it was adopted. The local fiscal body must send DOR a certified copy of each ordinance adopted by certified mail not more than 10 days after the ordinance is adopted.

Insurance Premium Tax: If a lower Premium Tax rate helps Indiana’s domestic insurance companies expand, corporate and personal income tax collections could be increased, benefitting counties with local option income taxes.

If an insurance company relocated outside the state because of lower Premium Tax rates in other states relative to Indiana’s 2.0% rate, local property tax burdens could be shifted to other taxpayers.

State Agencies Affected: Auditor's Office; Department of State Revenue; Department of Insurance.

Local Agencies Affected: All.

Information Sources: Department of State Revenue; Joint Committee on Taxation; Department of Insurance.