

COMMITTEE ON LEGISLATIVE RESEARCH
OVERSIGHT DIVISION

FISCAL NOTE

L.R. No.: 0293-01
Bill No.: SB 4
Subject: Business and Commerce; Taxation and Revenue
Type: Original
Date: January 15, 2015

Bill Summary: This proposal would increase the amount of phased in personal income tax rate reduction and business income deduction in current law.

FISCAL SUMMARY

| ESTIMATED NET EFFECT ON GENERAL REVENUE FUND | | | | |
|---|------------|------------|-----------------------------------|------------------------|
| FUND AFFECTED | FY 2016 | FY 2017 | FY 2018 | Fully Implemented * |
| General Revenue* | \$0 | \$0 | \$0 or (\$104,035,000) | (\$476,033,000) |
| Total Estimated Net Effect on General Revenue* | \$0 | \$0 | \$0 or (\$104,035,000) | (\$476,033,000) |

* This proposal would be implemented in five increments, dependent on increased general revenue receipts. The proposal could be fully implemented as early as FY 2022.

| ESTIMATED NET EFFECT ON OTHER STATE FUNDS | | | | |
|--|------------|------------|------------|-------------------|
| FUND AFFECTED | FY 2016 | FY 2017 | FY 2018 | Fully Implemented |
| | | | | |
| | | | | |
| Total Estimated Net Effect on Other State Funds | \$0 | \$0 | \$0 | \$0 |

Numbers within parentheses: () indicate costs or losses.
 This fiscal note contains 11 pages.

| ESTIMATED NET EFFECT ON FEDERAL FUNDS | | | | |
|---|----------------|----------------|----------------|--------------------------|
| FUND AFFECTED | FY 2016 | FY 2017 | FY 2018 | Fully Implemented |
| | | | | |
| | | | | |
| Total Estimated Net Effect on <u>All</u> Federal Funds | \$0 | \$0 | \$0 | \$0 |

| ESTIMATED NET EFFECT ON FULL TIME EQUIVALENT (FTE) | | | | |
|---|----------------|---------------|----------------|--------------------------|
| FUND AFFECTED | FY 2016 | FY 201 | FY 2018 | Fully Implemented |
| | | | | |
| | | | | |
| Total Estimated Net Effect on FTE | \$0 | \$0 | \$0 | \$0 |

Estimated Net Effect (expenditures or reduced revenues) expected to exceed \$100,000 in any of the three fiscal years after implementation of the act.

| ESTIMATED NET EFFECT ON LOCAL FUNDS | | | | |
|--|----------------|----------------|----------------|--------------------------|
| FUND AFFECTED | FY 2016 | FY 2017 | FY 2018 | Fully Implemented |
| Local Government | \$0 | \$0 | \$0 | \$0 |

FISCAL ANALYSIS

ASSUMPTION

Officials from the **Department of Revenue (DOR)** assume this proposal would provide an additional annual reduction in the state's highest personal income tax rate, and would also increase the percentage of business income that could be exempted from state income tax under provisions included in SB 509 (2014).

Section 143.011,2(2), RSMo. - Individual Income Tax Rate Reductions:

DOR officials stated changes to this provision would increase the reduction to the maximum individual income tax rate by an additional one-tenth of one percent beginning in 2017. The maximum rate could not be reduced lower than five percent, and the annual reduction would only occur if net general revenue in the previous year exceeded revenue in the highest of the previous three years by \$150 million.

DOR officials assume if net general revenue collections meet the income growth threshold, the estimated additional reduction in individual income tax revenue would be:

| | |
|--------------|-----------------|
| First Year: | \$77.7 million |
| Second Year: | \$152.6 million |
| Third Year: | \$228.4 million |
| Fourth Year: | \$306.4 million |
| Fifth Year: | \$378.4 million |

DOR officials also noted those amounts reflect the possible overall reduction in revenue from individual income tax collections due to the prospective rate reductions enacted in SB 509 (2014).

Section 143.022, RSMo. - Individual Income Tax Business Income Subtraction:

DOR officials stated changes to this provision would increase the subtraction of business income from federal adjusted gross income. Additionally, the legislation would provide owners of small corporations or partnerships a deduction in proportion to their share of ownership of the business. The proposal would increase the subtraction by an additional five percent once per year with a maximum subtraction of 50 percent.

ASSUMPTION (continued)

DOR officials stated for calendar year 2012, individual income tax filers reported \$16.4 billion in business income on their federal Form 1040s. The Department included amounts reported on federal Schedule C and Schedule E in their calculation. Of that \$16.4 billion reported, the Department estimates Missouri source income would be \$10.8 billion but noted the \$16.4 billion does not include returns filed by nonresidents where the federal information was not available.

DOR officials assume if net general revenue collections meet the growth threshold, the estimated additional reduction in individual income tax would be:

| | |
|---------------|----------------|
| First Year - | \$20.0 million |
| Second Year - | \$39.2 million |
| Third Year - | \$57.7million |
| Fourth Year - | \$75.5 million |
| Fifth Year - | \$92.5 million |

Administrative Impact

DOR officials assume this proposal would not have any administrative impact in addition to the impact previously identified in SB 509 (2014).

Officials from the **Office of Administration, Division of Budget and Planning (BAP)** assume this proposal would make changes to the state's personal income tax provisions.

The proposed changes would reduce the maximum individual income rate in 0.2% steps from 6.0 % to 5.0% in five increments and note that current law would reduce the rate to 5.5% in five increments. This proposed rate reduction would be subject to a growth trigger of \$150 million in net general revenue above the highest of the three previous fiscal years, and could begin in 2017. The proposal would eliminate current language requiring the bracket for income subject to the maximum tax rate to be eliminated.

BAP officials note this proposal could have an additional impact on the calculation required by Article X, Section 18(e) of the state constitution.

ASSUMPTION (continued)

This proposal would also increase the prospective incremental business income subtraction from 5% to 10%, allowing a phased in reduction of the taxable portion of business income from 0% to 50.0% over five increments. Current law provides for 5% annual reductions up to a total 25% reduction.

BAP officials assumed business income would include Missouri source net profit on federal Schedule C and Schedule E, Part II. This provision would be subject to a growth trigger of \$150 million in net general revenue above the highest of the three previous fiscal years, and could begin in the 2017. Each additional reduction would be based on the previous fiscal year's collections.

BAP officials noted it is very difficult to identify Missouri-source business income from available data. If the proportion of taxable income that is Missouri - source business income is greater than that estimated for this analysis, then the loss of revenues would be higher. BAP officials also noted this analysis makes no attempt to quantify the loss of revenues that might occur if taxpayers alter their filing status to take advantage of the business income deduction.

The estimated revenue reduction in millions of dollars, based on tax year 2012 data, is shown below.

| | |
|-------------|---------|
| First Year | \$97.7 |
| Second Year | \$192.5 |
| Third Year | \$286.3 |
| Fourth Year | \$381.4 |
| Fifth Year | \$469.0 |

Oversight assumes some taxpayers would change their business organization or their filing status to qualify for this deduction but is not able to estimate the number or amount of taxes paid by such filers or the potential impact this factor could have on state revenues. and will not include any revenue reduction for that potential impact.

ASSUMPTION (continued)

BAP officials assume the proposal would become effective for FY 2018, and also assume taxpayers would adjust withholdings and estimated tax declarations beginning with the first year the proposal becomes effective, and officials assume this could reduce Total State Revenues that year by an estimated \$35.2 million. When fully phased-in (FY 2022), the proposal would reduce Total State Revenues by an estimated \$469 million. The BAP estimate of revenue reduction in millions of dollars for the changes in estimated tax and withholding follows.

| | |
|---------|---------|
| FY 2017 | \$35.2 |
| FY 2018 | \$131.8 |
| FY 2019 | \$226.3 |
| FY 2020 | \$320.6 |
| FY 2021 | \$413.0 |
| FY 2022 | \$469.0 |

BAP officials noted their analysis is based on the most recent available data for 2012 and noted actual revenue impacts may be substantially different due to the five-year difference.

Officials from the **University of Missouri - Economic and Policy Analysis Research Center (EPARC)** assume this proposal would make the following changes to existing individual income tax provisions.

Current law provides for the maximum tax rate on personal income to be reduced over a period of years. For each year that a general revenue growth trigger is met, the top rate will be reduced by 0.1%. The rate will continue to be reduced until it is lowered from 6% to 5.5%. This proposal would increase the amount by which the top rate is reduced; for each year the trigger is met, the top rate would be reduced by 0.2%. The top rate would continue to be reduced until it is lowered to 5%.

Current law also provides a business income deduction to be phased in over a period of years. For each year that a general revenue growth trigger is met, the deduction will be increased by 5%. Once fully phased in, individual taxpayers will be able to deduct up to 25% of their business income. This proposal would increase the deduction. For each year the trigger is met, the deduction amount would be increased by 10%. Once fully phased in, individual taxpayers would be able to deduct up to 50% of their business income.

ASSUMPTION (continued)

Since the current law passed in 2014 (SB 509) will not become effective until 2017, EPARC officials assumed the best estimate of the impact for this proposal bill would entail using the proposed changes in tax provisions to simulate its impact within the context of existing legislation using the most recent 2013 baseline data and then subtracting the re-estimated impact of SB 509 using the current 2013 baseline data. Therefore, the first portion of their response re-estimated the fiscal impact of SB 509 using the most recent 2013 baseline data. The second portion of the response estimated the fiscal impact of the changes proposed in this legislation using the same 2013 baseline data.

The summary portion of this response calculated and discussed the impact of this proposal to the extent it would reduce Individual Income Tax revenues and Net General Revenue beyond existing provisions.

Oversight notes that EPARC provides estimates on the combined impact of all individual income tax changes rather than separate estimates of the individual changes due to the interaction of the proposed changes on the Net Tax Due estimates in their simulations. The following tables indicate the EPARC estimates of revenue reduction, in millions of dollars, for this proposal.

Table 1 - SB 509 (2014) Rate Changes and Business Income Deductions using 2013 Baseline Data

| Year | Maximum Tax Rate | Business Income Deduction | Estimated Income Tax | Estimated Revenue Reduction |
|----------|------------------|---------------------------|----------------------|-----------------------------|
| Baseline | 6.0% | 0 | \$5,124.717 | |
| Year 1 | 5.9% | 5% | \$4,987.040 | \$137.677 |
| Year 2 | 5.8% | 10% | \$4,872.735 | \$251.982 |
| Year 3 | 5.7% | 15% | \$4,757.994 | \$366.723 |
| Year 4 | 5.6% | 20% | \$4,647.596 | \$477.121 |
| Year 5 | 5.5% | 25% | \$4,538.237 | \$586.480 |

ASSUMPTION (continued)

Table 2 - Proposed SB 4 Rate Changes and Business Income Deductions using 2013 Baseline Data

| Year | Maximum Tax Rate | Business Income Deduction | Estimated Income Tax | Estimated Revenue Reduction |
|----------|------------------|---------------------------|----------------------|-----------------------------|
| Baseline | 6.0% | 0 | \$5,124.717 | |
| Year 1 | 5.8% | 10% | \$4,883.005 | \$241.712 |
| Year 2 | 5.6% | 20% | \$4,670.426 | \$454.291 |
| Year 3 | 5.4% | 30% | \$4,460.167 | \$664.550 |
| Year 4 | 5.5% | 40% | \$4,258.396 | \$866.321 |
| Year 5 | 5.0% | 50% | \$4,062.404 | \$1,062.513 |

Table 3 - Estimated Additional Impact of Proposed SB4 Provisions

| Year | Maximum Tax Rate | Business Income Deduction | Estimated Impact for Existing Provisions (SB 509) | Estimated Impact for SB 4 Provisions with SB 509 | Estimated Impact for SB 4 (Net Change) |
|----------|------------------|---------------------------|---|--|--|
| Baseline | 6.0% | 0 | | | |
| Year 1 | 5.9% | 5% | \$137.677 | \$241.712 | \$104.035 |
| Year 2 | 5.8% | 10% | \$251.982 | \$454.291 | \$292.309 |
| Year 3 | 5.7% | 15% | \$366.723 | \$664.550 | \$292.827 |
| Year 4 | 5.6% | 20% | \$477.121 | \$866.321 | \$389.200 |
| Year 5 | 5.5% | 25% | \$586.480 | \$1,062.513 | \$476.033 |

ASSUMPTION (continued)

Oversight notes the changes in this proposal would be effective beginning January 1, 2017, and the first income tax returns would be filed reflecting these changes in January, 2018 (FY 2018). Oversight is aware some filers would reduce their income tax withholding or their estimated tax payments in anticipation of a tax reduction but does not have information as to the impact of those adjustments. For fiscal note purposes, Oversight would include the revenue reductions in the year in which the affected tax returns would be filed; however, the first year this proposal would have an impact would be FY 2018.

Oversight is not able to predict whether the general revenue growth trigger would be met for any future year; however, for fiscal note purposes Oversight will indicate an impact of \$0 (general revenue growth trigger not met) to the estimated first increment impact of \$104,035,000 (general revenue growth trigger met for 2017) for FY 2018. Oversight notes the proposal could become fully implemented (general revenue growth trigger met for five years in total) as soon as FY 2022 at which time the fiscal impact would be \$476,033,000.

Based on information provided by the Office of Administration - Division of Budget and Planning (BAP) in a prior session, between 25% and 50% of the first year impact could affect the year the proposal becomes effective. This impact would be due to individual filers adjusting their tax withholding and estimated payments. For this proposal, that would indicate revenue reductions between \$26.008 million at 25% and \$52.017 million at 50% in the fiscal year before the proposal becomes effective.

Oversight considers this to be a prospective impact and will not include the potential revenue reduction for taxpayers adjusting their withholding and estimated payments in this fiscal note.

Officials from the **Office of the Secretary of State (SOS)** assume many bills considered by the General Assembly include provisions allowing or requiring agencies to submit rules and regulations to implement the act. The SOS is provided with core funding to handle a certain amount of normal activity resulting from each year's legislative session. The fiscal impact for this fiscal note to the Secretary of State's Office for Administrative Rules is less than \$2,500. The SOS recognizes that this is a small amount and does not expect that additional funding would be required to meet these costs. However, we also recognize that many such bills may be passed by the General Assembly in a given year and that collectively the costs may be in excess of what our office can sustain with our core budget. Therefore, we reserve the right to request funding for the cost of supporting administrative rules requirements should the need arise based on a review of the finally approved bills signed by the governor.

ASSUMPTION (continued)

Officials from the **Joint Committee on Administrative Rules** assume this proposal would not have a fiscal impact to their organization in excess of existing resources.

| <u>FISCAL IMPACT - State Government</u> | FY 2016 (10 Mo.) | FY 2017 | FY 2018 | Fully Implemented * |
|---|---------------------|---------|---------|---------------------|
|---|---------------------|---------|---------|---------------------|

GENERAL REVENUE

Revenue reduction

| | | | | |
|-------------------------------|-----|-----|---------------------------|-----------------|
| Individual income tax changes | \$0 | \$0 | \$0 or (\$104,035,000) | (\$476,033,000) |
|-------------------------------|-----|-----|---------------------------|-----------------|

ESTIMATED NET EFFECT TO GENERAL REVENUE*

| | | | | |
|--|------------|------------|---|------------------------|
| | <u>\$0</u> | <u>\$0</u> | <u>\$0 or</u> <u>(\$104,035,000)</u> | <u>(\$476,033,000)</u> |
|--|------------|------------|---|------------------------|

* This proposal would be implemented in five increments, dependent on increased general revenue receipts. The proposal could be fully implemented as early as FY 2022.

| <u>FISCAL IMPACT - Local Government</u> | FY 2016 (10 Mo.) | FY 2017 | FY 2018 | Fully Implemented |
|---|---------------------|------------|------------|-------------------|
| | <u>\$0</u> | <u>\$0</u> | <u>\$0</u> | <u>\$0</u> |

FISCAL IMPACT - Small Business

Owners of small businesses would pay lower income taxes if this proposal is implemented.

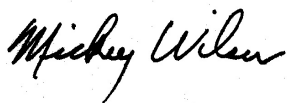
FISCAL DESCRIPTION

The proposed legislation would increase the amount of phased in personal income tax rate reduction and business income deduction in current law.

This legislation is not federally mandated, would not duplicate any other program and would not require additional capital improvements or rental space.

SOURCES OF INFORMATION

Office of the Secretary of State
Joint Committee on Administrative Rules
Office of Administration
 Division of Budget and Planning
Department of Revenue
University of Missouri
 Economic and Policy Analysis Research Center



Mickey Wilson, CPA
Director
January 15, 2015

Ross Strobe
Assistant Director
January 15, 2015