

COMMITTEE ON LEGISLATIVE RESEARCH
OVERSIGHT DIVISION

FISCAL NOTE

L.R. No.: 4324-18
Bill No.: Truly Agreed To and Finally Passed SS #3 for SCS for SB Nos. 509 & 496
Subject: Business and Commerce; Taxation and Revenue - Income
Type: Original
Date: April 29, 2014

Bill Summary: This proposal would modify provisions relating to income taxes.

FISCAL SUMMARY

ESTIMATED NET EFFECT ON GENERAL REVENUE FUND			
FUND AFFECTED	FY 2015	FY 2016	FY 2017
General Revenue *	\$0	\$0	\$0
Total Estimated Net Effect on General Revenue Fund *	\$0	\$0	\$0

* This proposal would have a fiscal impact beginning in FY 2018. The fully implemented revenue reduction in the fifth year would be \$620,987,000.

ESTIMATED NET EFFECT ON OTHER STATE FUNDS			
FUND AFFECTED	FY 2015	FY 2016	FY 2017
Total Estimated Net Effect on <u>Other</u> State Funds	\$0	\$0	\$0

Numbers within parentheses: () indicate costs or losses.

This fiscal note contains 16 pages.

ESTIMATED NET EFFECT ON FEDERAL FUNDS			
FUND AFFECTED	FY 2015	FY 2016	FY 2017
Total Estimated Net Effect on <u>All</u> Federal Funds	\$0	\$0	\$0

ESTIMATED NET EFFECT ON FULL TIME EQUIVALENT (FTE)			
FUND AFFECTED	FY 2015	FY 2016	FY 2017
Total Estimated Net Effect on FTE	0	0	0

Estimated Total Net Effect on All funds expected to exceed \$100,000 savings or (cost).

Estimated Net Effect on General Revenue Fund expected to exceed \$100,000 (cost).

ESTIMATED NET EFFECT ON LOCAL FUNDS			
FUND AFFECTED	FY 2015	FY 2016	FY 2017
Local Government	\$0	\$0	\$0

FISCAL ANALYSIS

ASSUMPTION

Officials from the **Office of Administration - Division of Budget and Planning (BAP)** assume this proposal would have statewide impact, and would impact the calculation required under Article X, Section 18(e) of the Missouri Constitution.

BAP officials noted this proposal would make numerous changes to income taxation. Since the changes impact the individual income tax, the combined impact of the changes may differ from the sum of the individual estimates below.

BAP officials also noted this proposal would be effective for 2017, but data from 2011 is the most recent available for analysis, and the actual revenue impact may be substantially different due to the six year difference.

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

BAP officials noted this proposal would reduce the maximum individual income tax rate from 6.0% to 5.5%, in a series of incremental 0.1% steps. Each reduction would be based on the previous fiscal year's collections, but the first reduction could be implemented as of January 1, 2017. Based on 2011 data, BAP officials estimated that each 0.1% reduction in the rate would reduce Total State Revenues by at least \$68.8 million, depending on the current rate in effect. BAP officials assume the fully phased-in proposal would reduce Total State Revenues by an estimated \$343.8 million, not considering the impact from 143.011.2(4) noted below.

BAP officials assume if the first reduction occurs for 2017, taxpayers would adjust withholdings and estimated tax declarations beginning in January 2017. Those adjustments could reduce Total State Revenues in FY 2017 by an estimated \$24.8 million.

ASSUMPTION (continued)

143.011.2(4), RSMo. - Elimination of Top Bracket:

BAP officials noted the proposal includes a requirement for the Department of Revenue to eliminate the bracket for income subject to the top rate of tax once the top rate of tax has been reduced to five and one-half of a percent.

BAP officials stated the elimination of the top bracket could occur as early as 2022 and would set the top rate of tax for Missouri taxable income over \$8,000 but not over \$9,000 at \$260 plus 5 ½% of the excess over \$8,000; BAP officials assume there would be no income tax for individuals with Missouri taxable income over \$9,000. BAP officials stated the cost of this provision is estimated to be \$4.8 billion per year based on 2011 data, and noted the actual amount may be substantially different when the provision is implemented due to inflationary and other factors that may occur between 2011 and 2022.

BAP officials also noted that net individual income taxes paid for 2011 were \$4.936 billion, and assume this provision would have eliminated about 97% of individual income tax collections if it had been in effect for that tax year. For FY 2012, total net general revenue collections were \$7.341 billion, so \$4.801 billion would be about a 65% reduction of that amount.

Finally, BAP officials noted the estimated impacts of the remaining provisions of the bill, particularly those for the fifth and final year, do not consider the elimination of the top bracket. BAP officials stated the result of this bracket elimination is that the remaining impacts would be smaller than they would otherwise have been.

Oversight notes the proposed language in this section would require the elimination of the top rate bracket once the top rate of tax has been reduced to five and one-half percent, and assumes five and one-half percent would become the new top tax rate for taxable income over \$8,000. If the proposal is implemented and is interpreted to exempt taxable income over \$9,000 from tax, the resulting revenue reduction would be significantly greater.

ASSUMPTION (continued)

Section 143.011,3 and 143.011.4, RSMo. - Individual Income Tax Rate Brackets Indexed for Inflation:

Officials from the **Office of Administration - Division of Budget and Planning (BAP)** noted this proposal would adjust the income tax brackets based on the increase in the cost of living. BAP officials assume this means that, instead of \$1,000 increments, the increments would be adjusted based on the rate of inflation. For example, if inflation is 1%, the brackets would be based on \$1,010 increments.

BAP officials noted the annual rates of inflation as reported on the United States Department of Commerce, Bureau of Labor Statistics (BLS) website. The highest rate since 1984 was 5.4% and the lowest rate was (0.4) percent.

Applying those figures to 2011 data, BAP officials estimated the impact to Total State Revenues would be a \$28.6 million reduction at the 5.4% inflation rate. Similarly, the impact to Total State Revenues would a \$5.2 million increase at the (0.4%) inflation rate.

Officials from the **Department of Revenue (DOR)** stated their estimates of impact are based on the effective date of January 1, 2017. DOR officials also assume the impact to revenues would continue into future fiscal years outside the reporting period.

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

Changes to this provision would reduce the top individual income tax rate by 1/10th of one percent beginning in 2017. The top rate could not be reduced lower than five and one-half percent, and the reduction would only occur if net general revenue collected in the previous year exceeded the highest of the previous three years by \$150 million.

ASSUMPTION (continued)

If net general revenue collections meet the threshold, DOR officials assume a reduction in revenue from individual income tax of the following:

First Year:	\$68.8 million
Second Year:	\$137.5 million
Third Year:	\$206.3 million
Fourth Year:	\$275.1 million
Fifth Year:	\$343.8 million

DOR officials stated these figures reflect the possible overall reduction in revenue from individual income tax collections due to the rate reduction in Section 143.011 and note additional reductions in revenue are reflected below in the analysis of the operative section.

DOR officials noted additionally, the brackets in this section would be adjusted annually by the percent increase in inflation. DOR officials assume the current \$1,000 increments would be adjusted based on the Consumer Price Index. For example, if the Consumer Price Index increase is one percent, the brackets would be based on \$1,010 increments. Based on information reported on the Bureau of Labor Statistics website, the highest rate since 1984 was 5.4%.

Using 2011 data, DOR officials estimated Total State Revenue may be reduced by as much as \$28.6 million if calculated at the 5.4 percent rate, and note that estimate does not include the impact of section 143.011.2(4). DOR officials assume this piece of the legislation would eliminate the bracket for income subject to the top rate of tax once the top rate has been reduced to five and one-half percent. The elimination of the top bracket would leave the top rate of tax for Missouri taxable income over \$8,000 but not over \$9,000 at \$260 plus 5 ½ percent of the excess over \$8,000. There would be no income tax for individuals with Missouri taxable income more than \$9,000. DOR officials assume there would be a revenue reduction of \$4.8 billion per year as a result of this elimination.

DOR officials stated their estimate is based on data from 2011, and assume because of inflation and other factors that may occur between now and 2022, the actual impact to Total State Revenue may be considerably different when the elimination of the top bracket is implemented.

ASSUMPTION (continued)

Administrative Impact

DOR officials assume Personal Tax would be required to make form changes and support OA - ITSD (DOR) programming support to update systems to include the deduction. DOR officials assume Personal Tax would need two additional Revenue Processing Technicians I for error correction and correspondence.

DOR officials also assume Collections and Tax Assistance (CATA) would have increases in adjustments to individual income tax returns due to the calculation to reduce taxable income, increasing taxpayer contacts. DOR officials assume CATA would require two additional Tax Collection Technicians I for additional contacts to the delinquent and non-delinquent tax line and one Revenue Processing Technician I for additional contacts to the field offices.

DOR officials assume Withholding Tax would be required to update withholding tables for any changes in the tax rate, forms and the online calculator but would not require any additional employees.

IT impact

DOR officials assume OA - ITSD (DOR) would require 768 FTE hours of programming for new tax tables and rates.

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

Officials from the **Office of Administration - Division of Budget and Planning (BAP)** noted this provision would phase in a subtraction of business income from taxable income in a series of incremental 5% steps, to a maximum subtraction of 25%. Business Income would include Missouri source net income from the filer's federal Schedule C and Schedule E, Part II. Each reduction would be based on the previous year's collections, but the first deduction could be implemented January 1, 2017.

ASSUMPTION (continued)

Based on 2011 data, BAP officials estimated the following impacts, by year:

First Year	(\$19.2 million)
Second Year	(\$38.3 million)
Third Year	(\$57.2 million)
Fourth Year	(\$76.1 million)
Fifth Year	(\$94.9 million)

BAP officials assume if the first reduction is implemented for 2017, taxpayers would adjust withholdings and estimated tax declarations and payments beginning in January 2017. Those adjustments could reduce Total State Revenues in FY 2017 by an estimated \$6.9 million.

BAP officials noted it is very difficult to identify Missouri source business income from available data, and if the proportion of taxable income from Missouri sources is greater than the estimated amounts for this analysis, then the loss of revenues would be higher.

Also, BAP officials noted this analysis makes no attempt to quantify the loss of revenues that could occur if taxpayers alter their filing status to take advantage of the business income deduction.

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

Officials from the **Department of Revenue (DOR)** noted this section would allow for the subtraction of business income from the filer's federal adjusted gross income. Additionally, the legislation would allow owners of small corporations or partnerships a deduction in proportion to their share of ownership of the business. The legislation would increase the subtraction by five percent per year with a maximum subtraction of 25 percent.

DOR officials stated for calendar year 2011, individual income tax filers reported \$14.4 billion in "business" income on their federal Form 1040s. The Department included the total reported on Schedule C and Schedule E in the calculation; of the \$14.4 billion reported, the Department estimates Missouri source income at \$9.8 billion. DOR officials also noted the \$14.4 billion does not include those returns filed by nonresidents where the federal information is not available.

ASSUMPTION (continued)

If the net general revenues meet the established threshold, Department officials estimated the following reduction in individual income tax:

First Year	\$19.4 million
Second Year	\$38.6 million
Third Year	\$57.7 million
Fourth Year	\$76.7 million
Fifth Year	\$95.8 million

Administrative Impact

DOR officials assume Personal Tax would require form changes and ITSD-DOR programming support to update systems to include the deduction. DOR officials assume Personal Tax would require two additional Revenue Processing Technicians I for error correction and correspondence.

DOR officials assume Collections and Tax Assistance (CATA) would use the additional FTE requested under section 143.011 to implement this section.

Section 143.151, RSMo. - Additional Individual Deduction:

Officials from the **Office of Administration - Division of Budget and Planning (BAP)** noted this provision would provide an additional deduction of \$500 from Missouri Adjusted Gross Income for taxpayers with less than \$20,000 of adjusted gross income. Based on 2011 data, BAP officials estimated this provision would reduce Total State Revenues by \$11.7 million annually. Since the first reduction occurs for 2017, BAP officials assume taxpayers would adjust withholdings and declarations beginning in January 2017 which would reduce Total State Revenues in FY 2017 by an estimated \$4.2 million.

Officials from the **Department of Revenue (DOR)** noted this section would allow Missouri residents with an adjusted gross income of less than \$20,000 to claim an additional \$500 deduction beginning January 1, 2017; it would also allow the same deduction for the taxpayer's spouse if the spouse's income is also below \$20,000.

Based on the number of qualifying taxpayers in calendar year 2011, the Department estimates a reduction of individual income tax of \$11.7 million per year.

ASSUMPTION (continued)

Administrative impact for the Department of Revenue

Officials from the **Department of Revenue (DOR)** provided a response for this proposal which indicated significant costs to implement the proposal, beginning in FY 2017.

Section 143.011 Administrative Impact

DOR officials assume Personal Tax would be required to make form changes and support OA - ITSD (DOR) programming to update systems to include the deduction. Two additional Revenue Processing Technicians I would be required for error correction and correspondence. Collections and Tax Assistance (CATA) would have additional adjustments to individual income tax returns due to the calculation to reduce taxable income, increasing taxpayer contacts, and would require two additional Tax Collection Technicians I for additional contacts to the delinquent and non-delinquent tax line and one Revenue Processing Technician I for additional contacts to the field offices. Withholding tax would be required to update withholding tables for changes in the tax rate, forms and the online calculator, but no additional employees would be required. OA - ITSD (DOR) would require 768 hours of programming to make changes to DOR systems for the new tax tables and rates.

Section 143.022 Administrative Impact

Personal Tax would be required to make form changes and support OA - ITSD (DOR) to update systems to include the deduction. Two additional Revenue Processing Technicians I would be required for error correction and correspondence. Collections and Tax Assistance would use the additional FTE requested under section 143.011 to implement this section. OA - ITSD (DOR) would require 504 hours of programming to make changes to Individual Tax systems; If COINS captures the small corporation business income deduction, an additional 1,512 FTE hours of programming would be required to make changes to Corporate Tax systems.

Section 143.151 Administrative Impact

Collections and Tax Assistance would use the additional FTE requested under section 143.011 to implement this section. OA - ITSD (DOR) would require 504 hours of programming to make changes to DOR systems.

ASSUMPTION (continued)

Summary of DOR Cost Estimate

The DOR response indicated a total of seven additional employees and 3,288 hours of programming to make changes to DOR systems. The cost is shown in the following table.

Salaries	\$188,401
Benefits	\$96,094
Equipment	\$49,540
Office Expense	\$8,001
Programming	<u>\$89,672</u>
Total	<u>\$431,708</u>

Oversight assumes DOR would require additional employees beginning in January, 2018 (FY 2018) when the first individual income tax returns reflecting the changes in this proposal would be filed. Oversight also notes that a high percentage of individual income tax returns are completed by professional preparers or with computer software and assumes the proposal could be implemented with fewer employees and at lower cost than the DOR estimate. Oversight will not include an estimate of the DOR cost to implement this proposal since those costs would be incurred outside the period covered in this fiscal note.

Combined Impact of Individual Income Tax Changes

Officials from the **University of Missouri - Economic and Policy Analysis Research Center (EPARC)** assume this proposal would allow additional individual income tax exemptions for filers with less than \$20,000 in Missouri adjust gross income, would reduce individual income tax rates, and would allow a “business income” subtraction for individual income tax filers. In addition, this proposal would increase the individual tax rate brackets by the rate of inflation as measured by changes in the Consumer Price Index.

Specifically, the proposal would allow a resident with Missouri adjusted gross income less than \$20,000 an additional deduction of \$500. The proposal would reduce the maximum individual income tax rate by one-tenth of one percent each year if the previous fiscal year’s net general revenue collections exceed net general revenue collections in the three previous fiscal years by at least \$150 million. The reduction in the individual income tax rate could only happen once per year and, reductions would cease once the maximum individual tax rate reaches 5.5%.

ASSUMPTION (continued)

If the previous fiscal year's net general revenue collections exceed net general revenue collections for the three previous fiscal years by at least \$150 million, the proposal would begin implementing a "business income" subtraction for individual income tax filers of 5% of "business income". The proposal would increase this "business income" subtraction by 5% each year, if the previous fiscal year's net general revenue collections exceeds net general revenue collections for the three previous fiscal years by at least \$150 million until a maximum "business income" subtraction of 25% is reached.

EPARC officials noted the additional deduction for low-income filers would not be contingent on the net general revenue growth requirement, although the reduction in individual income tax rates and the "business income" subtraction would be contingent on the net general revenue growth requirement. EPARC officials noted they are unable to predict future net general revenue levels.

EPARC officials stated their assumption that the net general revenue growth requirement would be met every year until the reduction in the top individual income tax rate reaches 5.5% in five years (2021), which would also allow the "business income" subtraction to reach its maximum of 25% in five years (2021).

EPARC officials analyzed information from the Bureau of Labor Statistics, and noted the average increase in the CPI for All Urban Consumers for the United States over the last three years was approximately 2.3%. EPARC officials stated they used that figure to adjust the tax rate brackets.

ASSUMPTION (continued)

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 changes on the Net Tax Due estimates in their simulations. The following table indicates the EPARC estimates of revenue reduction, in millions of dollars, for this proposal.

Year	Maximum Tax Rate	Business Income Deduction	Additional Personal Deduction	Increase in Rate Brackets	Estimated Income Tax	Estimated Revenue Reduction
Baseline	6.0%	0	\$500	2.3%	\$5,109.439	
Year 1	5.9%	5%	\$500	2.3%	\$4,963.670	\$145.679
Year 2	5.8%	10%	\$500	2.3%	\$4,842.233	\$267.206
Year 3	5.7%	15%	\$500	2.3%	\$4,720.819	\$388.620
Year 4	5.6%	20%	\$500	2.3%	\$4,603.986	\$505.453
Year 5	5.5%	25%	\$500	2.3%	\$4,488.452	\$620.987

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 which is outside the period covered by this fiscal note.

Based on information provided by the Office of Administration - Division of Budget and Planning, between 25% and 50% of the first year impact could affect the year the proposal becomes effective. In this case that would indicate revenue reductions between \$36.4 million at 25% and \$72.8 million at 50%

ASSUMPTION (continued)

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.

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

<u>FISCAL IMPACT - State Government</u>	FY 2015 (10 Mo.)	FY 2016	FY 2017
GENERAL REVENUE FUND			
<u>Revenue reduction - DOR</u>			
Individual income tax changes *	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
ESTIMATED NET EFFECT ON GENERAL REVENUE FUND *	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

* This proposal would have a fiscal impact beginning in FY 2018. The fully implemented revenue reduction in the fifth year would be \$620,987,000.

<u>FISCAL IMPACT - Local Government</u>	FY 2015 (10 Mo.)	FY 2016	FY 2017
	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

FISCAL IMPACT - Small Business

This proposal would reduce income taxes for small business corporations and owners of small businesses.

FISCAL DESCRIPTION

This proposal would make several changes to current individual income tax provisions.

The proposal would modify the individual income tax rate table. The maximum tax rate on personal income would be reduced by one-half of a percent over a period of years, beginning in 2017. Each rate reduction would be one-tenth of a percent. No reduction could go into effect unless net general revenue collected in the previous fiscal year exceeded net general revenue collected in any of the three preceding fiscal years by at least \$150 million. When the rate reductions are fully phased in, the maximum rate of tax on individual income would be five and one-half percent.

The proposal would require the brackets for individual income tax to be adjusted each year, beginning in 2017, for the percentage increase in inflation.

The proposal would create an individual income tax deduction for business income, and would implement it in phases over a period of years, beginning in 2017. Each increase in the deduction amount would be five percent. Once fully phased-in, taxpayers would be allowed to deduct twenty-five percent of their business income. An increase in the deduction percentage could not be implemented unless net general revenue collected in the previous fiscal year exceeded net general revenue collected in any one of the three fiscal years prior to such year by at least \$150 million. Shareholders of S corporations and partners in partnerships would be allowed a proportional deduction based their share of ownership.

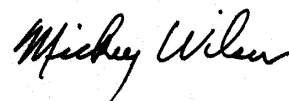
FISCAL DESCRIPTION (continued)

The proposal would increase the currently personal exemption amount of \$2,100 for individual income taxes by \$500 for individuals with a Missouri adjusted gross income of less than \$20,000.

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
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April 29, 2014

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