XII. Taxation: Legislative Reform

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The 1973 Indiana General Assembly enacted the first substantial changes in the laws affecting state and local revenues and expenditures in Indiana since 1963.[1] These changes are administratively complex, will result in substantial shifts in tax burdens among various taxpayers, and will force local governments to look to specific, nonproperty sources for additional revenues.

The changes can be better understood if it is recognized that the legislature was not attempting with this tax program to provide additional revenue for additional governmental expenditures. Indeed, the overriding consideration was to effect a direct, visible reduction in property taxes and to curb future increases in such taxes. Since local governments obviously could not be expected to exist without increases in expenditures, the program also had to include provisions for alternative revenue sources.

The direct, visible reduction in property taxes is provided by credits, funded through increases in state sales and corporate income taxes, while the curb on future property tax increases comes through a freeze of 1973 property tax levies or rates. The alternative revenue sources for schools are state funds and for all other units of local government, local income taxes. Much of the complexity of the program stems from legislative efforts, however feeble, (1) to require each group of taxpayers, *e.g.*, corporations, unincorporated business, individuals, etc., to contribute new taxes in relatively the same proportion in which they will receive relief from property taxes and (2) to make provision for the obvious inequities which will be created by freezing present property tax revenue levels for *every* taxing unit in the state.[2]

A. Direct Reduction Of Property Taxes

Whatever the facts, the legislature was persuaded that the

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[1]Ind. Pub. L. Nos. 45, 47, 50, 236 (April 24, 1973).

[2]Every governmental unit with authority to levy property taxes is a taxing unit—92 counties, 1009 townships, 305 school corporations, over 550 cities and incorporated towns, plus hundreds of other special function districts, *e.g.*, library, sanitation, conservation, and park districts.

property tax in Indiana was too high and that a rollback was necessary. Thus was born the twenty percent property tax credit for *every* property taxpayer in the state.[3] The new law provides that beginning in the calendar year 1974, and each year thereafter, every taxpayer will receive a credit of at least twenty percent of his property tax, a plan which, on the surface, seems simple and equitable. But in some taxing units, federal general revenue sharing funds were used to replace property taxes in 1973. Applying the credit *after* this replacement would penalize taxpayers in those taxing units vis-a-vis taxpayers residing where revenue sharing funds had not been so used and thus act as a disincentive for counties to use revenue sharing funds for tax reduction in the future. The same problem will occur in counties which choose to adopt a local income tax because the statute requires that a portion of such tax be used to reduce property tax levies.[4] If the twenty percent credit were simply applied to the amount of tax actually due from each taxpayer, counties which have adopted the local income tax, and thus reduced property taxes, would receive less money from the state than if they had not adopted it.

To account for these problems, the program as finally adopted, requires that the credit for each taxpayer be computed based on his actual tax liability *plus* any amounts by which his taxes were reduced because revenue sharing or county income tax funds were used to replace property taxes.[5] This means, of course, that county auditors must compute two tax liabilities for each taxpayer —his actual liability and his theoretical liability, computed as if there had been no revenue sharing or local income tax funds used to replace property taxes.

The twenty percent credit will cost the state approximately $224 million each year[6] and obviously could not be funded without increased state taxes. So a Property Tax Replacement Fund[7] was created into which will be paid fifty percent of the doubled state sales tax *(i.e.,* approximately the amount attributable to the in-

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[3]IND. CONST. art. 10, § 1, requiring uniform assessments and rates, prohibits most forms of selective property tax relief. Numerous recent legislative efforts to amend this section have failed.

[4]Ind. Pub. L. No. 50, § 5 (April 24, 1973).

[5]Ind. Pub L. No. 45, § 3 (April 24, 1973).

[6]Indiana Comm'n on State Tax and Financing Policy, Cash Flow for Tax Packages as Passed April 13, 1973 (Xerox).

[7]Ind. Pub. L. No. 45, § 3 (April 24, 1973).

crease in rate from two percent to four percent). Food for home consumption was exempted from the sales tax and the eight dollar per person credit against state income taxes originally enacted in lieu of such food exemption was eliminated. The doubling of the sales tax and the food exemption were effective on May 1, 1973 while elimination of the credit is effective for 1973 tax returns. Thus taxpayers will have paid a two percent sales tax on food purchases for the first four months of 1973, for which they will receive no income tax credit. Other changes in the Indiana sales tax law include an elimination of the sales tax exemption for materials purchased by speculative builders[8] and narrowing of the exemption for purchases by public utilities.[9]

State taxes on corporations were both increased and decreased as part of this new package, some of the increased revenue going into the Property Tax Replacement Fund and some into the state's general fund. Much of the criticism leveled at the legislature's tax program when first unveiled was that individuals would pay most of the increased taxes while business would receive most of the property tax relief.[10] Initially the package in-

[8]IND. CODE § 6-2-1-39 (1971). This rather unique exemption for speculative builders has been part of Indiana's sales tax law since 1965. The justification for it has been that it made the sale of speculative homes competitive with older homes which, as real property, are not subject to sales tax. The contract builder, however, has always been and continues to be required to pay sales tax on items to be incorporated in the building.

[9]When the sales tax was originally adopted in 1963, public utilities were granted an exemption from sales tax on all their purchases of personal property, a benefit not shared by manufacturers generally. *Id.* § 6-2-1-39(6). The latter were exempted only from paying tax on purchases to be directly used in production. The 1973 amendment limits the public utility exemption to purchases of tangible personal property to be directly used in direct production. The change means that utilities will pay an estimated $7.5 million more in additional sales taxes annually. Cash Flow for Tax Package, *supra* note 5. The 20% annual property tax credit, however, will result in a reduction of some $29 million in property taxes paid by utilities.

[10]A uniform percentage reduction in property tax will inevitably result in greater tax relief to businesses simply because business pays most of the property tax. The distribution of property taxes paid in Indiana is as follows:

Farm	14.7%
Other Business	40.8%
Utilities	11.9%
Residential and Individual	32.6%

Indiana State Board of Tax Commissioners, Property Tax Analysis, March 1, 1971, Payable 1972, December 6, 1972. *See also* Indianapolis Star, Jan. 27, 1973, at 2; Indianapolis News, Jan. 25, 1973, at 4.

creased only the corporate adjusted gross income tax from two percent to four percent. This tax is paid by fewer than eight percent of the total number of taxpaying corporations in Indiana,[11] yet all the remaining corporations, which are subject to the gross income tax, would receive substantial property tax relief under the twenty percent property tax credit program. Unwilling to increase the gross income tax, the legislature finally compromised on an increase in the corporate adjusted gross income tax to three per cent, the imposition of an entirely new Supplemental Corporate Net Income Tax on *all* corporations, to be paid *in addition* to the existing gross and adjusted gross income taxes,[12] and a decrease in the gross income tax by five per cent each year, thus phasing it out over a twenty year period.[13]

B. Local Income Taxes

Since the amount of property tax which may be collected in the future has now been strictly limited, counties have been given the option of adopting a local county-wide adjusted gross income tax to be levied on individuals residing or working in the county and collected for the county by the state. To be effective such tax must be adopted by a majority vote of the county council and may be adopted at the rate of one percent, three-quarters of one percent, or one-half of one percent. Once adopted the tax may not be rescinded for a period of four years, although presumably the county council could either raise or lower the rate during that four year period.[14]

Since property taxes generally are to be frozen under this program, this local income tax is the only significant source of revenue for additional expenditures for *all* local units of government (except schools). Generally, it is in the cities where the demand for additional governmental expenditures and costs of services are rising most rapidly. Yet the county council is given the authority to impose or not impose the tax. One can easily imagine a county council asking why it should take the blame

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[11]Memorandum from Administrator, Indiana Department of Revenue, Income Tax Division, to Director, Commission on State Tax and Financing Policy, March 22, 1973.

[12]Ind. Pub. L. No. 50, § 8 (April 24, 1973). The tax base of the new Supplemental Corporate Net Income Tax is the same as the corporate adjusted gross income tax base, less the amount of the gross or adjusted gross income tax for which the corporation is liable. The new tax is to be levied initially at the rate of 2%, increasing to 2½% in 1975, and 3% in 1977.

[13]Ind. Pub. L. No. 47, § 1 (April 24, 1973).

[14]Ind. Pub. L. No. 50, § 7 (April 24, 1973).

for imposing a new additional tax on county residents in order to provide money for cities over which the county council has no control. Indeed, only thirty-four of ninety-two counties have, in fact, adopted the local income tax for 1974.[15]

Perhaps in order to make it easier for county councils to adopt the tax, the legislature mandated that some portion of the income tax must be used for further property tax relief (in addition to the twenty percent direct credit to taxpayers). The higher the rate at which the tax is adopted, the greater the proportion which must be used for tax relief initially. However the amount to be so used diminishes each year for three years and remains constant thereafter.[16]

While this requirement may, indeed, make it easier for county councils to adopt the tax (by allowing them to tell their constituents that they are providing tax relief rather than simply raising additional revenue for government expenditures), it will serve to make administration of the local income tax extremely complex. The amounts set aside for property tax relief (called Property Tax Replacement Credits) are to be distributed to every taxing unit in the county (including schools) in the proportion that each taxing unit's property tax levy bears to the total county levy. But, as with the twenty per cent credit, any federal revenue sharing funds used to reduce property tax levies and any of the remaining portion of the local income tax used to further reduce property taxes must be added back to the levy before the property tax replacement credits are distributed.[17] To do otherwise would penalize taxpayers in jurisdictions in which taxes were so reduced. Thus, as with the twenty per cent credit, a *theoretical* computation of tax levies will be required for *every* taxing unit in each county which has adopted the tax.

Article 10, section 1 of the Indiana Constitution has been interpreted to mean that with certain specified exceptions all property within any given taxing unit must be assessed and taxed

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[15]Indiana Dep't of State Revenue, Circulars CO-3 (June 5, 1973) & CO-3A (July 20, 1973).

[16]Ind. Pub. L. No. 50, § 7 (April 24, 1973).

[17]Indiana has forty-one school corporations which encompass territory in more than one county. If one of those counties adopts a local income tax, the property tax replacement credit distributed to the school corporation reduces the tax rate only for taxpayers who reside in the county levying the income tax. *Id.*

at the same rate.[18] This provision is intended to insure that taxpayers in like circumstances are charged at the same rate for the same governmental services. But in a situation in which one county levies a local income tax and another does not, the school tax rate in the former county will be lower than the rate charged in the latter county. Query whether this is not a violation of this consitutional provision? Assume, for example, two similar corporations, both located within the school district, one in the county which has levied the income tax, the other in a county which has not. Since corporations are not subject to the local income tax, the one located in the adopting county will enjoy a lower property tax rate and therefore a lower overall charge for school costs than the similar corporation in the county which has not adopted the local income tax.

The remainder of the local income tax not used for property tax relief (called Certified Shares) is not distributed to all the taxing units in the county but only to "participating taxing units," *i.e.*, the county, the townships, and the cities and towns within the county,[19] and may be used for additional expenditures or further property tax reduction. Schools are excluded because the tax package provides no alternative local revenue source for school corporations. All *additional* funds for schools will now come from the state. The distribution of the certified share portion of the income tax is to be based on a so-called "attributable tax levy," defined as the levy of the unit entitled to receive a certified share plus the tax levies of any special taxing district or agency performing a function reasonably attributable to the participating tax unit. The newly created Local Property Tax Control Board is charged with responsibility for determining the attributable tax levy for each unit entitled to receive these certified shares. For example, a county-wide library district would presumably be attributable to the county, but to which unit would a special sanitation district be attributable, or a library district encompassing less than the entire county? Since the law provides that the unit receiving a certified share may appropriate or transfer any part of the funds to any unit whose levy was attributable to it,[20] the legislature seems to have made this distribution unnecessarily complex. It could seemingly have accomplished the same goal by simply providing for distribution of the certified shares to all taxing units except schools.

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[18]Bright v. McCollough, 27 Ind. 223 (1866).

[19]Ind. Pub. L. No. 50, § 7 (April 24, 1973).

[20]*Id.*

The great variety of possible local income tax rates will complicate withholding procedures for employers. A large employer drawing employees from a multi-county area may be required to withhold state or local income taxes at as many as five different withholding rates. An employer located in a county which has not adopted the tax withholds no local income tax for residents of his own county. If he is located in a county which has adopted the local tax, he must withhold at whatever the local rate is for residents of the county, at the rate of one-quarter of one percent for his employees who reside in a nonadopting county, and for those employees who reside in an adopting county, at the appropriate rate in those counties. To minimize the employer's problem of keeping track of employees' changes of residence, the legislature provided that an individual's residence as of January 1 each year would govern tax liability. The law provides specifically that "subsequent changes during a calendar year of an individual's residence . . . shall not alter or affect such individual's liability for county income taxes based upon his residence as determined in accordance with the standards and date herein before established."[21] Thus, an individual who on January 1 resided in a county which had adopted the local income tax would be liable for the tax to that county for the entire calendar year even though he may have moved out of it on January 2. Admittedly, this simplifies the administrative problems, but query whether such county, in fact, continues to have jurisdiction over this individual for purposes of taxing his income?

C. Property Tax Limits

This new tax program severely limits the amount of money which any unit of local government may raise from the property tax beginning in 1974. For those counties which have adopted a local income tax, the property tax *levy* for each taxing unit is frozen at its 1973 level, that is, the actual amount of money raised from the property tax. In these units property tax rates will decrease as assessed valuation increases and vice versa. For those counties which have *not* adopted a local income tax the property tax *rate* imposed in 1973 is frozen.[22] In these cases the only additional local tax revenue available will come from increases in assessed valuation. The freeze generally does not apply to levies or rates for debt or lease-rental obligations and, once again, any amounts of federal revenue sharing funds used in 1973 to reduce

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[21] *Id.*

[22] *Id.*

the tax levies must be added back to the levy before the freeze is applied.

Like the twenty percent credit to all taxpayers, this freeze of tax rates or levies seems fairly simple on the surface, but it may create some serious inequities, and will certainly result in significant shifts in local tax burdens. The county council will now determine the source of additional local revenue—either the income tax or increases in assessed valuations. If the local income tax is adopted and tax levies frozen, most of the additional burden will fall on individuals since corporations are not subject to the local income tax. Not only will corporations have some of their property taxes replaced with the income tax, paid only by individuals, but they will pay no more in property taxes than in 1973, and, indeed, if assessed valuations increase, their property tax *rates* will be lower. Alternatively, if no local income tax is adopted and tax *rates* are thereby frozen, only those taxpayers whose assessed valuations increase will pay more tax. Since real property assessments tend not to change except in reassessment years (every sixth year), only businesses with increasing personal property valuations or those businesses or individuals engaged in new construction will pay the additional tax burden.

Further, increased revenues from increases in assessed valuation obtained by a county's rejecting the local option income tax may be short lived. The statute seems to state that in adopting counties the 1973 property tax levy is frozen, without regard to when the local income tax is adopted,[23] thus a county is forced to forego any such increased revenues if it chooses at a later date to adopt the income tax. This provision would certainly seem to serve as a disincentive for growing counties ever to adopt the income tax. It is questionable whether the legislature intended such a result.

Other shifts in tax burdens will occur. For example, a county with a substantial number of nonresident property taxpayers which adopts the income tax has given a windfall to those nonresidents. They will not be subject to the income tax and since the levy is frozen, they will pay no higher property taxes while continuing to enjoy the benefits of the county's services at the expense of the county residents.

D. Local Property Tax Control Board

Anticipating that these very severe financial restrictions could

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[23] *Id.*

work a hardship on some communities, the legislature created a new state level board called the Local Property Tax Control Board.[24] Communities which feel they cannot carry out their functions and responsibilities within these financial limitations may appeal for relief through the State Board of Tax Commissioners to this new Tax Control Board. The Board is authorized to recommend one or more of five very specific types of relief, *i.e.*,

1. A loan to the community from the state,
2. Permission to reallocate that portion of the local income tax statutorily required to be used for property tax replacement,
3. Permission to increase the property tax levy in cases of annexation or extension of governmental services to areas where property had not been previously subject to property taxes for that service,
4. Permission to impose a property tax levy of up to $1.50 for those communities which have not imposed an ad valorem property tax levy for four or more years,[25] and
5. Permission to increase the property tax levy in order to provide or operate community mental health and mental retardation centers.[26]

Perhaps mindful of the fact that since 1937 Indiana statutes have contained meaningless maximum property tax rate limits of $1.25 or $2.00, which may be exceeded in cases of "reasonable necessity" by authority of the State Board of Tax Commissioners,[27] the legislature gave the Local Tax Control Board no general power to grant relief in emergency or unforeseen situations. With this specific listing of the forms of relief the Local Tax Control

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[24]*Id.* The current members of the Board are: Richard L. Worley, State Board of Accounts; Robert J. Burns, State Board of Tax Commissioners; Garnett Inman, Mayor, New Albany; Hugh A. Barker, Public Service Indiana; James T. Robison, former state legislator; Howard Goodhew, South Bend; and Virgil King, Hebron. Representative William L. Long, Lafayette, and Senator Joseph W. Harrison, Attica, are ex officio members.

[25]This provision applies to those few communities which have been able in the past to operate exclusively on nonproperty tax revenues.

[26]Ind. Pub. L. No. 50, § 7 (April 24, 1973).

[27]IND. CODE §§ 6-1-46-3, -5 (1971). Virtually every taxing unit in the state levies a total tax rate of more than $2.00. Presumably, in each case, there is "reasonable necessity" for doing so.

Board may grant, the legislature assumes it has anticipated all possible reasons that a local government would need financial relief —a somewhat bold, and probably erroneous, assumption. An absolute freeze of property tax rates or levies cements into the system whatever inequities or errors existed at the time the freeze was imposed.

One example will suffice. In Brown County, 1973 budgets and tax rates were certified by the State Board of Tax Commissioners using an assessed valuation overstated by the county auditor by $2.9 million, due largely to errors in transcription. Specifically almost $1.5 million of the error occurred because one personal property tax assessment of $14,660.00 became, in the transcription process $1,466,000.00.[28] If Brown County had not, in fact, adopted a local income tax, the 1973 certified tax rate would have been frozen—a rate based on an erroneous assessed valuation. The Local Tax Control Board would not have had statutory authority to allow levy of a higher tax rate in Brown County next year. This is the kind of situation which obviously the legislature could not have been expected to anticipate, but it also illustrates the folly of the legislature's refusal to give some administrative agency the authority to make exceptions when necessary.

E. Conclusion

This new tax package is a response to pressure, from whatever source, for a reduction in property taxes. To fund the reduction, new taxes had to be imposed. To make the tax increases tolerable to the electorate, the legislature felt it needed iron-clad guarantees that property taxes would not increase again in the future—thus the rate and levy freezes, with all their attendant complications. Unwilling to assume responsibility for imposition of any further additional taxes, the legislature put the burden on local governments to adopt or not adopt the local income tax. But equally unwilling to allow local government the pleasure of spending the money it raises, the legislature then mandated the use of a portion of the money. The net result of these interlocking considerations is an extremely complex package of restrictions which local government must learn to understand. Many questions remain unanswered and the legislature in 1974 may be called upon to consider some major revisions in the package.

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[28] The Brown County Democrat, June 13, 1973, at 1, col. 8.