Corporate Taxes Important to Meeting Kentucky’s Needs
Reform, not Elimination is Key to Helping Economy

By Jason Bailey

Summary
Legislative leaders in the House and Senate have floated the idea of eliminating Kentucky’s corporate income tax. But rather than leading to economic growth as supporters claim, getting rid of the tax is likely to have the opposite effect. Substantial research has found that the corporate income tax has little to no impact on location and investment decisions because it is such a small part of the overall cost of doing business. Elimination would not just fail to attract business; it also would cost Kentucky money it needs for investments critical to creating jobs, like education. Further, elimination would mean major corporations could avoid responsibility for helping pay for public services from which they benefit. Kentucky’s corporate income tax needs improvement rather than elimination. Closing loopholes and more carefully scrutinizing numerous tax breaks would shore up revenue and make sure the tax is evenly applied.

How Kentucky’s corporate taxes work
Corporations in Kentucky must pay a tax on the net income they earn from their operations, and the state uses a formula for multi-state corporations to attribute a portion of their net income to Kentucky. Like every other state but Idaho, Kentucky also has a limited liability entity tax that applies to businesses that receive the same legal protections as corporations even if they are not incorporated.¹

The corporate income tax has graduated rates ranging from 4 percent to 6 percent based on the size of net income. Corporations facing net losses don’t pay corporate income taxes, and can carry forward their losses to reduce up to twenty years of future tax liability. Limited liability entities pay the lesser of two taxes: a tax on gross receipts of 9.5 cents per $100 or a tax on gross profits of 75 cents per $100. Small businesses with gross receipts or profits of less than $3 million are exempt from that provision, and businesses with between $3 million and $6 million of gross receipts or profits have their taxes under that provision reduced. There is a minimum limited liability entity tax of $175.

Kentucky has had corporate taxes since 1936. The state’s present system was adopted in 2005 as part of a package of measures aimed at addressing what had become a major loophole in the state’s taxes.² Many businesses, including large, multi-state corporations, had been forming themselves as limited liability companies to avoid taxation at the business entity level. The legislation required limited liability entities to pay the corporate tax and it put in place an alternative calculation to assure that all businesses made some contribution for the public services from which they benefit. The state also closed some other loopholes, including adopting a national standard for whether businesses are taxable in Kentucky and ending the practice of corporations applying net losses to previous years’ taxes in order to get refunds.³

At the same time, the legislation lowered corporate income tax rates (the top rate went from 8.25 percent to 6 percent) and eliminated the corporate license tax. In 2006, the legislature rolled back some of these changes--replacing the alternative calculation with a separate limited liability entity (LLE) tax and increasing the exemption for small businesses in the LLE tax.⁴
Kentucky experienced a general decline in corporate tax revenues as a share of the General Fund from 1989 until the 2005 changes (Figure 1). In part because of the timing of the elimination of the corporate license tax and the phase-down of the corporate income tax rate as well as the structure of the temporary reforms, corporate revenues as a share of the General Fund temporarily increased in 2006 and 2007. But following the 2006 cuts, corporate tax revenues have fallen back down and assumed the previous trend of decline as a share of the General Fund.5

**Figure 1**

Corporate Taxes as a Share of General Fund Revenue

Sources: Office of the State Budget Director, Kentucky Revenue Department

Corporate tax important for supporting Kentucky services
The more diverse a state’s tax system, the better chance it has of weathering tough times in part because different types of taxes react in distinct ways to various economic conditions. This tenet is vividly on display in 2011. The recession and its aftermath have brought higher unemployment and a sluggish housing market which, in turn, mean weak revenue from the sales tax, individual income tax and property tax. But because of high business profits, corporate tax revenue is greater than anticipated. Kentucky now expects to receive 21 percent more from corporate taxes in 2011 than 2010, and 15 percent more than the official forecast. Along with the coal severance tax (which is bringing in more revenue than expected because the price of coal has increased), corporate taxes have helped prevent even deeper cuts in essential services.

Corporate income taxes also play the important role of helping to make the state’s overall tax system more equitable. Just like families and individuals, corporations benefit from public investments made in education, infrastructure, public safety and other areas. So it makes sense that businesses pay their fair share to support such services. At least a portion of the responsibility for paying corporate income taxes
falls on the shareholders of a business. In the case of large, multi-state corporations, these shareholders are disproportionately higher-income with a greater ability to pay taxes. Many of these shareholders are also out-of-state, and a corporate income tax may be the only way they help pay for the public services from which they and their business benefit.

Eliminating the corporate income tax creates a hole in the revenue system that must be replaced either with higher taxes on families and individuals, reduced investment in essential public services or some combination of both. Higher taxes would almost surely apply to residents in the state who are less able to pay, and reductions in public services would disproportionately harm Kentucky residents.

Jobs and economic development best served by smart investment
Proponents of eliminating the corporate income tax claim lower taxes would spur job creation and economic development because more businesses would choose to locate or expand in Kentucky. But the evidence casts serious doubt on this claim. Decades of research shows no significant relationship between state taxes and economic growth for two reasons. One is the relatively trivial costs of the corporate income tax relative to other location factors and costs (like land or labor). The other is the importance of high quality public services — which would be jeopardized by cutting revenues -- to the creation of jobs and economic growth.

Serious academic research shows a weak relationship between cutting state taxes and growing state economies, and suggests economic gains only if there are no subsequent cuts in public spending on education, transportation and other building blocks of a strong economy. But in reality, eliminating business taxes can only result in lower spending on necessities. That’s because like just about every state (Vermont is the only exception), Kentucky requires itself to have a balanced budget. So any tax cuts must be balanced dollar for dollar by lower public spending unless someone else’s taxes are raised. And even if taxes could be cut without reducing spending, an analysis of studies produced over the past 20 years shows that a 10 percent reduction in all state and local business taxes would result in an increase in state business activity of only about 2 percent.7

Even that weak result must be seen in the proper context, which is that the corporate income tax is such a small part of all state and local business taxes that eliminating it is highly unlikely to influence businesses’ decision making. The state corporate income tax in Kentucky makes up only 7.5 percent of state and local business taxes, according to an analysis by the Council on State Taxation.8 Other research shows that all state and local business taxes are only two to three percent of the cost of doing business.9 That would suggest that the corporate income tax in Kentucky is well under a quarter of one percent of the cost of doing business in the state.10

It’s easy to see that such a small cost pales in comparison to other costs and location factors, including access to a skilled workforce, proximity to markets, access to support services and quality of infrastructure. Since all states but Nevada, Wyoming and South Dakota have a corporate income tax or similar business tax, the differences between most states are quite modest. What’s more, state corporate income taxes are deductible from federal corporate income taxes, further lessening the differences between states because businesses in states with higher state corporate income taxes have their higher costs offset by lower federal corporate income taxes.

Since distinctions between state corporate income taxes are minor, cuts to or elimination of state corporate income taxes are likely to result in windfall gains for corporations rather than prompting them to make economic development investments that will benefit the state. Because businesses for the most part make location and investment decisions based on other factors, corporate tax cuts are largely rewards for decisions they would make anyway. Another reason to doubt that elimination of the corporate income tax will help the state is that lower taxes are not conditioned on any specific activity on the part of businesses (such as new investment or hiring more people) and are therefore even more likely to result in a windfall.

The cost-effectiveness of business tax reduction for economic development was part of a study of state economic development programs produced in 2007 by the University of Kentucky’s Center for Business
and Economic Research (CBER). The study found that a group of tax breaks had only a weak impact on jobs and earnings. It estimated that each new job created by businesses that received benefits from the programs cost the state $26,775—over ten times more expensive than the $2,510 per job estimated in the same study for a Kentucky job-training program.\textsuperscript{11}

A follow-up CBER study examining why Kentucky has grown more slowly than other southern states like North Carolina and Georgia in recent years found the main reason was not taxes, but a deficit in the “stock of knowledge.”\textsuperscript{12} In other words, other states had more to offer businesses in terms of education, skills and the capacity to innovate. The report also mentioned the importance of amenities like cultural activities and a high quality of life to other states’ growth. Public investment is critical to making progress in those areas.

The only state that has eliminated its corporate income tax in recent years is Ohio. But at the same time, Ohio put in place a commercial activity tax on businesses’ gross sales, so it did not end all taxation at the business level. It did, however, eliminate property taxes on business machinery, equipment and inventory, for a net loss to the state of over $1 billion a year. There is no evidence that the tax cut helped Ohio’s economic performance: the state’s share of national income, employment and investment has dropped slightly since 2005.\textsuperscript{13}

There is, however, significant evidence that cost-effective investment in public services is important to long-term economic growth. Surveys of the literature by economists Timothy Bartik and Ronald Fisher report that the majority of studies find a positive relationship between expanded public services and economic growth.\textsuperscript{14} These surveys note that some public services promote economic growth by reducing private sector costs (such as roads and highways), while others increase the productivity of business inputs (such as education and health services). Economist Robert Lynch notes that: “Businesses need to know that they can rely on high-quality, well-administered public services to facilitate the conduct of their enterprises. Snow removal and flood control must be reliable and timely; roads, bridges and highways must be maintained in good repair; fire protection and police services must be there when needed; the justice system must be professional, impartial and quick to resolve contract disputes, and the schools and colleges must help to generate a skilled and well-trained workforce.”\textsuperscript{15}

**Closing loopholes would improve corporate income tax**

While it is important to maintain Kentucky’s corporate income tax as part of a diverse, balanced tax system that can contribute to jobs and economic growth, there are improvements that can be made to the tax to make it a more productive resource for investments crucial to Kentucky’s future, and help level the playing field between local businesses and large, multi-state corporations. Kentucky can do more to close loopholes and scrutinize corporate tax breaks.

Over the past few decades, large, multi-state corporations have developed strategies to avoid state corporate income taxes by artificially shifting profits to special subsidiaries or tax shelters. Some corporations avoid taxes by, for example, setting up subsidiaries in Delaware, or by using a tax shelter called a “captive Real Estate Investment Trust” originally established by Wal-Mart. These companies avoid responsibility to help pay for public services from which they benefit.

A tax filing requirement called combined reporting can address that problem. It requires functionally-related corporations to be treated as a single entity for tax purposes. The profits of related corporations are combined or added together for tax purposes, preventing tax liability from being artificially shifted between units of essentially the same business. Of the 46 states with corporate income taxes, 23 have put in place combined reporting -- but not Kentucky.\textsuperscript{16} Had Kentucky required combined reporting, the state would have gained $27 million to $54 million in additional corporate income tax revenue in 2009 according to a state analysis based on the experience of other states.\textsuperscript{17}

Combined reporting is fully consistent with a robust state economy. In the past 10 years, every state except Alaska has experienced a net loss of manufacturing jobs. And yet there is no indication that the presence of combined reporting has played a role in a state’s relative success in retaining such jobs. Indeed, of the 10 states that lost the smallest shares of their manufacturing employment in the past 10
years, eight were combined reporting states. Conversely, of the 10 states that lost the greatest share of manufacturing jobs, nine were non-combined reporting states. There appears to be no correlation between a state’s adoption of combined reporting and its relative success in retaining what are theoretically the most potentially footloose firms and their jobs.18

Studies conducted in several states have revealed that most large multi-state corporations have facilities in, and therefore are subject to corporate income taxes in, numerous combined reporting states.19 If such corporations happily do business in combined reporting states year-in and year-out, there is no reason to think they would shun Kentucky for future investment were the state to enact combined reporting.

Other loopholes should also be closed. For example, many large, multi-state corporations earn some income that is not taxed in any state because they do not meet the minimum threshold for taxation in states where they do have some activity. This “nowhere income” can be legally taxed by enacting a “throwback rule” which simply requires that the income be taxed in the state where the product originated. About 25 states already have this rule in effect.20

In a second example, Kentucky’s definition of business income may allow some corporations to avoid taxation on a portion of income earned during the course of doing business. For example, irregular transactions including the sale of assets like plant and equipment or a reversion of funds back to a corporation that has over-funded its pension plan may not meet Kentucky’s definition of income. The U. S. Supreme Court has made clear that states can fix their definition of business income to include such transactions. Six states have addressed this loophole by changing the definition of business income to mean “all income which is apportionable under the Constitution of the United States,” as recommended by legal scholar Walter Hellerstein.21

In addition to closing loopholes, Kentucky should critically evaluate various tax credit and tax subsidy programs that result in lower corporate income tax revenue to make sure they are meeting their objectives in a cost-effective manner. For example, in legislation passed in 2009 railroads may receive credit against costs incurred for maintenance, improvement, expansion or upgrades associated with the transport of fossil fuels or biomass, resulting in $3.3 million in lost corporate income tax revenue. Kentucky should put in place a process to regularly review these tax subsidy and credit programs and require that they be ended after a decade if at that time a formal assessment and legislative committee review determines they are not achieving their desired purpose or are not worth the lost revenue. Table 1 lists selected tax credit and tax subsidy programs along with the estimated lost corporate income tax revenue.

<table>
<thead>
<tr>
<th>Summary Description</th>
<th>2011 Revenue Loss (Millions of $)</th>
<th>2012 Revenue Loss (Millions of $)</th>
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<tbody>
<tr>
<td>Kentucky Industrial Development Act</td>
<td>Tax credits for investment by manufacturing companies</td>
<td>20.0</td>
</tr>
<tr>
<td>Film Industry Tax Credit</td>
<td>Provides refundable income tax credits to companies that film or produce motion pictures in Kentucky</td>
<td>15.0</td>
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<tr>
<td>Recycling Credit</td>
<td>Tax credits for the installed cost of recycling or composting equipment</td>
<td>13.4</td>
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<tr>
<td>Kentucky Rural Economic Development Act</td>
<td>Tax credits for investment by manufacturing companies in distressed rural areas</td>
<td>10.2</td>
</tr>
<tr>
<td>Biodiesel and Renewable Diesel Tax Credit</td>
<td>Credit of $1 a gallon for producing or blending biodiesel or renewable diesel fuels</td>
<td>10.0</td>
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</table>
### Ethanol and Cellulosic Ethanol Tax Credit
Credit of $1 a gallon for producing ethanol or cellulosic ethanol

| Credit | 10.0 | 10.0 |

### Kentucky Jobs Development Act
Tax credits for investment by service or technology-related companies

| Credit | 6.0 | 5.6 |

### Environmental Stewardship Program
Provides tax credits for skills upgrade and equipment costs for projects “producing a new or improved manufactured product that has a lesser or reduced adverse effect on human health or the environment”

| Credit | 5.0 | 5.0 |

### Metropolitan College Program Tax Credit
Tax credits for tuition expenses paid by companies associated with Metropolitan College in Louisville

| Credit | 4.2 | 4.4 |

### Railroad Improvement Tax Credit
Tax credits for cost incurred for railroad maintenance and improvement and for railroad expansion or upgrades to accommodate the transport of fossil energy or biomass

| Credit | 3.3 | 3.4 |

### Kentucky Reinvestment Act Credit
Tax credits for reinvestment in an existing manufacturing company

| Credit | 2.0 | 2.2 |

### Kentucky Industrial Revitalization Act
Tax credits for investment by manufacturing or coal mining facilities under threat of closing

| Credit | 2.0 | 1.8 |

### Kentucky Business Incentive Program
Tax credits for investment by manufacturing, headquarters, service or technology companies

| Credit | 1.2 | 1.5 |

**Source:** Commonwealth of Kentucky Tax Expenditure Analysis 2010-2012

### Conclusion
Corporate taxes have long been an important part of how Kentucky meets its needs. Rather than resulting in meaningful job creation and economic development, eliminating or cutting the corporate income tax would harm the state’s ability to make investments that can help create jobs, build a strong economy and offer Kentuckians a good quality of life. The corporate income tax is a very small portion of the cost of doing business, making elimination unlikely to support growth especially given the impact of the lost revenue on education, infrastructure and other key public investments. While serious academic research questions the advantages of corporate tax cuts, most research supports the relationship between high quality public services and economic growth. Instead of more corporate tax cuts, Kentucky should work to eliminate loopholes in its corporate tax and more closely scrutinize credits, subsidies and other tax breaks that are a growing drain on needed revenue.

*The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important state fiscal and economic policy issues. KCEP seeks to create economic opportunity and improve the quality of life for all Kentuckians. Launched in 2011, the Center receives support from foundation grants and individual donors and is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP’s website at [www.kypolicy.org](http://www.kypolicy.org).*

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1. Incorporated businesses receive a credit for limited liability entity taxes paid against their corporate income tax owed, and individual owners of limited liability entities receive credit against individual income taxes for their portion of limited liability entity taxes paid. State limited liability entity taxes are catalogued in Michael Mazerov, “Reforming the Tax Treatment of S-Corporations and Limited Liability Companies Can Help States Finance Public Services,” Center on Budget and Policy Priorities, April 8, 2009, [http://www.cbpp.org/cms/index.cfm?fa=view&id=2771](http://www.cbpp.org/cms/index.cfm?fa=view&id=2771).

In technical terms, Kentucky shifted from a “physical presence” to a “doing business” nexus standard and eliminated its net operating loss carryback provision.

Includes revenue from corporate income tax, corporate license tax and limited liability entity tax. Does not include individual income taxes that ownes of pass-through entities pay, which are a form of business taxes.

Includes revenue from corporate income tax, corporate license tax and limited liability entity tax. Does not include individual income taxes that owners of pass-through entities pay, which are a form of business taxes. 2011 revenue based on third quarter 2011 interim estimate from the Office of the State Budget Director. 2012 revenue based on Consensus Forecasting Estimate as modified in 2011-2012 state budget.


See endnote 6. This analysis does not include individual income tax that owners of pass-through entities pay, which are a form of business taxes.


Putting in place a throwback rule involves expanding the definition of in-state sales in KRS 141.120(8)(c)(2)(b) to read “The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the purchaser’s state or the purchaser is the United States government.”

Previous Kentucky Legislative Research Commission analysis has estimated the additional revenue from enacting a throwback rule and expanding the definition of business income to be between $3 million and $13 million annually. Those estimates were made before Kentucky made major changes to its business taxes in 2005 and 2006. See the fiscal notes to HB 299, 2004 Regular Session, http://www.lrc.ky.gov/record/04rs/HB299.htm, and HB 276, 2005 Regular Session, http://www.lrc.ky.gov/record/05rs/HB276.htm.

Michael Mazerov, Testimony on combined reporting before the Rhode Island House Committee on Finance, Center on Budget and Policy Priorities, April 6, 2011. See the source cited in endnote 18 for an example.

The Kentucky Industrial Development Act, Kentucky Rural Economic Development Act and Kentucky Jobs Development Act were consolidated into the Kentucky Business Investment Program in 2009. Lost revenue from those programs reflects companies who received incentives in previous years and are still utilizing credits through the program.