

# MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy  
Research Brief

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## Special points of interest:

- Since 1992, corporate income tax revenues, as a percent of total tax revenues, have fallen by 49 percent.
- Corporate income tax revenues were 29 percent, or \$82 million, lower in fiscal year 2002 than in fiscal year 2001.
- The last time corporate income tax rates were changed was in 1985—they were raised



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## Kentucky's Corporate Income Tax: And the State's \$620 Million Budget Deficit

### Introduction

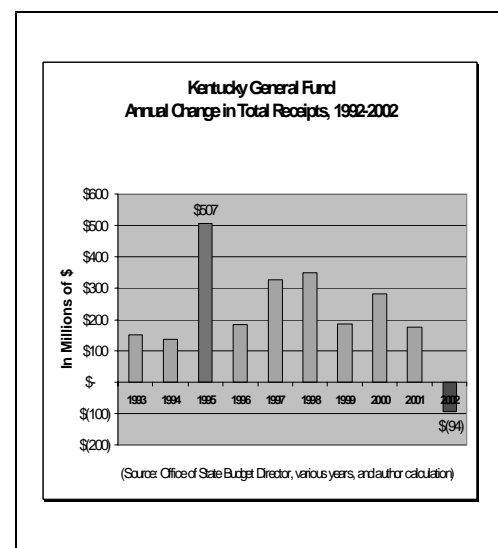
Kentucky presently faces a severe fiscal crisis. The state has a \$620 million budget shortfall for the fiscal year ended June 30, 2002, and has begun the new fiscal year without an enacted budget. Although the latter issue has been at least temporarily resolved by Governor Patton implementing a spending plan, the overriding concern is the state's faltering revenues. In fact, despite the new fiscal year being only one month old, revenues are already forecast to fall short of projections made just a few months ago.

Another indication of the budget severity is that general revenue fund receipts (i.e., state taxes, fees, investment income, and sundry sources) have declined, year-over-year, for the first time ever. Fiscal year 2002 total general fund revenues were \$6.5 billion, which is \$94 million less than in 2001. (See Graph 1.)

Although nearly all major revenue categories contributed to this decline, none performed as poorly as corporate income tax receipts. Falling 29 percent, or more than \$82 million in fiscal year 2002 compared to 2001, corporate income tax revenues were the proverbial thorn in the side of state reve-

nue forecasters last fiscal year. No other major revenue category fell as fast or as far as corporate income taxes.

In this Money Matters issue, therefore, we examine corporate income taxes in Kentucky. In particular, we review the corporate income tax structure and its revenue history. We conclude by examining the affect declining corporate income tax revenues have had on the state's budget.



Graph 1

Graph 1

**Tax Structure**

Kentucky’s corporate income tax is based upon a corporation’s net income. Net income is gross income less certain exemptions and deductions (see KRS 141.010 for more detail).

The corporate income tax rate structure is graduated. That is, as corporate net income rises, so does the corporate income tax rate. The corporate income tax rate starts at 4% for taxable net income of up to \$25,000, with the highest rate of 8.25% for taxable net income in excess of \$250,000. (See Table 1 below.) The last time the corporate tax rates were

Tax Rate	Amount
4%	First \$25,000 of taxable net income
5%	Amount in excess of \$25,000 but = \$50,000 of taxable net income
6%	Amount in excess of \$50,000 but = \$100,000 of taxable net income
7%	Amount in excess of \$100,000 but = \$100,000 of taxable net income
8.25%	Amount in excess of \$250,000

changed was in 1985; they were raised.

**Revenue History**

Corporate income tax revenues have been erratic. Year-to-year these revenues have fluctuated between periods of strong growth and steep decline. Take, for example, the 1995-1997 period. Corporate income tax revenues grew by 27 percent in 1995, fell by 17 percent in 1996 and grew by 3 percent in 1997; quite the roller coaster ride. (See Graph 2.)

Economists and budget analysts generally confess to not understanding why corporate tax revenues move so randomly. Despite sophisticated economic models, corporate tax revenues are frequently mis-forecast. It’s an unexplainable fact in economic modeling.

Off-target revenue forecasts,

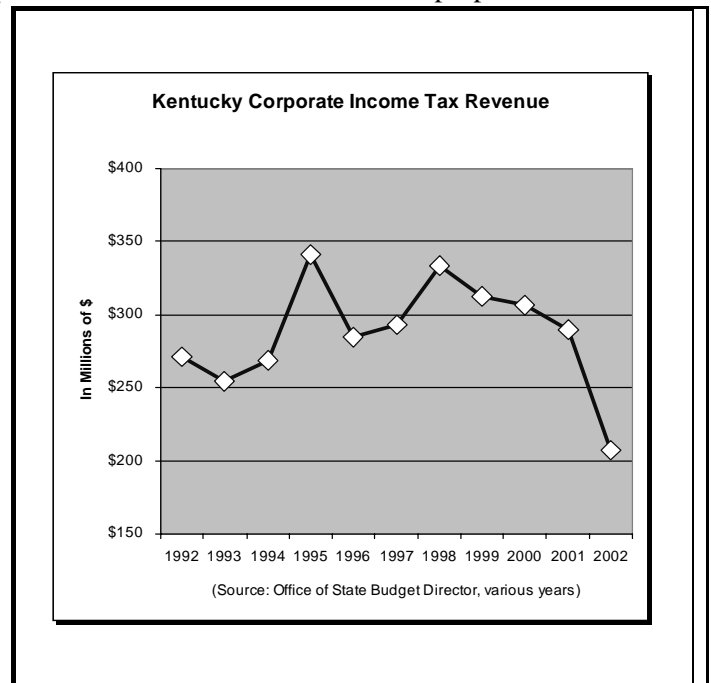
however, are not culpable when it comes to explaining actual changes in revenue. That is, revenue forecasts serve as the basis for how much revenue is expected at a future date. Actual figures represent—with certainty—what has occurred in the past.

Looking again at Graph 2, what appears particularly troubling is the fact that corporate income tax revenues have been declining since 1998—near the height of the last economic boom. Because corporate income taxes are based upon net income, as previously stated, one could have surmised that corporate income tax revenues should have been rising during this period. Instead, they were entering a four year revenue slide. Why?

Several possible explanations exist. First,

many corporations changed their charter from a corporation to a partnership or limited liability company, among others. This change affected how they reported their income for tax purposes. Partner-

*Corporate income tax revenues are erratic.*



Graph 2

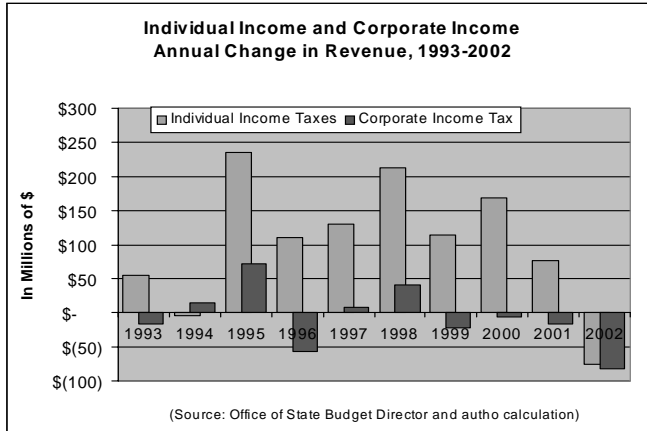
ships and limited liability companies file individual income tax returns, not corporate income tax returns. Consequently, if a sufficient number of businesses make this change, actual corporate income tax revenues would decline and individual income tax revenue would increase.

In principle, this explanation is appealing. It dismisses the notion that corporate income tax revenues have, on net, declined. It suggests that a similar amount of revenue is captured by the individual income tax.

Unfortunately, this argument does not hold to close scrutiny. To begin with, businesses do not change their charter simply due to a preference of paying individual income taxes instead of corporate income taxes. A higher motivation has to exist. One reason is lower tax liability.

Paying business taxes under the individual income tax code for some businesses makes fiscal sense. It reduces their tax liability, thereby, increasing their after tax income. Some businesses, therefore, may change their charter in order to lower the amount of business taxes they pay. In fact, considerable weight is given to this argument. According to Bill Fox, the legislature's consultant, and many others, businesses switching to a limited liability company have meant lost tax revenue for Kentucky. ("Report to the Subcommittee on Tax Policy Issues." February 27, 2002.)

Comparing individual and corporate income tax revenue growth does not yield strong evidence either that business taxes are "growing" individual income tax revenues. While individual income tax revenues have grown every year except 1994 and 2002, corporate income tax revenues have fallen in six years out of the last ten. This leaves no directly apparent connection between declining corporate income tax revenues and growing



Graph 3

individual income tax revenue. (See Graph 3.)

A second possible explanation for declining corporate income tax revenues could be slowing business activity. While some validity likely exists with this statement, it too cannot fully explain the drop in corporate income tax revenues. Corporate income tax revenues are based upon the prior year's business activity. Therefore, corporate net income would have had to start falling in 1998, the most recent year in which tax revenues grew, in order to make this case. Although general agreement exists that business activity was slowing as long ago as 2000, it is doubtful that the slowdown could be extended to 1998.

**Corporate Income Tax and the Budget**

Corporate income tax revenues have been declining as a percent of total state general fund tax revenues since 1992. From that time, corporate income tax revenues have fallen from 6.5 percent of total general fund tax revenues to 3.3 percent in 2002. This represents a 49 percent drop in just eleven years. By comparison, individual income tax revenues have grown from 40.2 percent to

*Filing under the individual income tax code has undoubtedly reduced corporate income tax revenues and business taxes in total.*

## Kentucky Youth Advocates

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43.0 percent of total general fund tax revenues, an increase of 6.8 percent over the same period. (See Graph 4.)

### Summary

From this brief review, we are able to conclude several facts about Kentucky's corporate income tax. They are listed below.

- 1) Corporate income tax revenues fluctuate significantly;
- 2) Corporate income tax revenues have declined from 6.5 percent of total general fund tax revenues between 1992 and 2002, respectively;
- 3) Individual income tax revenues as a percent of total tax revenues have increased from 40.2 to 43.0 percent of total general fund tax revenues in Kentucky between 1992 and 2001, respectively.

Kentucky Youth Advocates anticipates continuing to research and report on the corporate income tax as well as corporate license taxes and corporate subsidies. These are important topics especially given the state's current precarious fiscal situation.

