

# Money Matters

## Making Sense of the June 2006 Special Session Agenda: Fixing Business Taxes

Governor Fletcher, the House leadership, and the Senate leadership worked out a compromise tax bill for a special legislative session in late June 2006. The session includes “fixing” the gross receipts and gross profits taxes enacted in 2005 by exempting some small businesses, preserving the scheduled reduction of the top corporate income tax from 7 to 6 percent beginning January 1, 2007, and conforming certain state tax laws to federal law. The Governor’s official press statement estimates that 70,000 businesses—7 of every 8 businesses in the state—will benefit from the changes.<sup>1</sup>

### How Are Businesses Currently Taxed in Kentucky?

The “tax modernization” measure that passed in 2005 made several major changes in business taxes in Kentucky. The corporate license tax was eliminated. The top rate bracket for the corporate income tax (on net profits, if any) was reduced. A second alternative calculation was instituted. Businesses were required to pay the greatest of three taxes—the corporate income tax on net profits, a tax on gross receipts, or a tax on gross profits—or a minimum tax of \$175.

Businesses have complained that a tax imposed on anything but net profits is unfair and discourages entrepreneurship and economic development. The 2005 law also changed how limited liability corporations would be taxed, moving the tax from personal income tax to the new alternative calculation. Losses from one business could no longer be written off against profits from another business owned by the same individual(s).

### What is the Current Corporate Income Tax?

Kentucky corporate income tax is owed on net income—that is the earnings of a company remaining after all allowable expenses are subtracted from income, commonly called either net income or net profit. It may take companies years to earn profits and others do not consistently earn profits. The net income or net profits of a company are considerably smaller than their gross receipts or gross profits.

Kentucky’s corporate income tax is a graduated tax, with three brackets. The first \$50,000 of net income is taxed at a 4 percent rate. The next \$50,000 of net income is taxed at a 5 percent rate. Every dollar of net income above \$100,000 is currently taxed at 7 percent. However, Kentucky law passed in 2005 calls for that top rate to drop to 6 percent on January 1, 2007. The June 2006 special session would not make any changes in the scheduled rate reduction. Estimates prepared during the 2005 legislative session project a loss of \$35 million and \$37 million in corporate income tax in FY 2007 and FY 2008, respectively, from the rate reduction.<sup>2</sup> These revenue losses are already incorporated in the FY 2006-2008 biennial budget passed in the regular session earlier in 2006.

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Author

Debra Miller,  
dmiller@kyyouth.org

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2034 Frankfort Avenue  
Louisville, KY 40206  
(502) 895-8167  
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## How Does Kentucky Corporate Tax Compare to Surrounding States?

Kentucky and Ohio have graduated corporate income taxes and the remaining six surrounding states have flat rates. Even with the current top bracket of 7 percent, Kentucky taxes for the most profitable companies are lower than 4 of the surrounding states. As Table 3 shows, with the reduction of the top bracket to 6 percent, Kentucky corporate income tax rates will be the lowest in the region.

Today, for instance, a Kentucky company with a net income (net profit) of \$100,000 has an effective tax rate of 4.5 percent, below any of the surrounding states.<sup>3</sup> (See Table 1.) Dropping the top rate to 6 percent makes no difference in taxes for any corporation with a net income of \$100,000 or less since the threshold for that top rate is \$100,001 in net income.

**Table 1: Corporation A: Net Income of \$100,000**

State	Rate	Amount
West Virginia	9.0%	\$9,000
Indiana	8.5%	\$8,500
Illinois	7.3%	\$7,300
Ohio	6.8%	\$6,800
Tennessee	6.5%	\$6,500
Missouri	6.3%	\$6,300
Virginia	6.0%	\$6,000
Kentucky (until 12/31/2006, top rate @ 7%)	4.5%	\$4,500
Kentucky (after 01/01/2007, top rate @ 6%)	4.5%	\$4,500

For a corporation with net income of \$200,000, the current effective rate is 5.75 percent, still below all surrounding states. (See Table 2.) Dropping the top rate to 6 percent drops the effective rate to 5.25 percent, saving the corporation \$1,000, or one half of one percent of its net profit.

**Table 2: Corporation B: Net Income of \$200,000**

State	Rate	Amount
West Virginia	9.0%	\$18,000
Indiana	8.5%	\$17,000
Ohio	7.7%	\$15,400
Illinois	7.3%	\$14,600
Tennessee	6.5%	\$13,000

Missouri	6.3%	\$12,600
Virginia	6.0%	\$12,000
Kentucky (until 12/31/2006, top rate @ 7%)	5.75%	\$11,500
Kentucky (after 01/01/2007, top rate @ 6%)	5.25%	\$10,500

If a corporation's net income climbs to \$500,000, the current effective tax rate is 6.5 percent, lower than 4 surrounding states, tied with one, and higher than 2 other states. (See Table 3.) Dropping the top tax rate to 6 percent reduces the effective rate to 5.7 percent, ranking Kentucky's tax as the lowest of surrounding states. The tax savings for this hypothetical corporation would be \$4,000, or 0.8 percent of its net profit.

As corporate net income grows, the effective tax rate moves closer to the top bracket rate of either 7 percent or 6 percent. Kentucky's ranking relative to surrounding states does not differ no matter how high the corporation's net income becomes.

**Table 3: Corporation C: Net Income of \$500,000**

State	Rate	Amount
West Virginia	9.0%	\$45,000
Indiana	8.5%	\$42,500
Ohio	8.2%	\$41,000
Illinois	7.3%	\$36,500
Kentucky (until 12/31/2006, top rate @ 7%)	6.5%	\$32,500
Tennessee	6.5%	\$32,500
Missouri	6.3%	\$31,500
Virginia	6.0%	\$30,000
Kentucky (after 01/01/2007, top rate @ 6%)	5.7%	\$28,500

## Exempting Small Businesses from Gross Profits and Gross Receipts Taxes

Under the special session plan, businesses with either gross profits or gross receipts under \$3 million will be exempt from those taxes. They will, however, pay the \$175 minimum tax. For businesses with gross receipts or gross profits between \$3 million and \$6 million, the exemption will phase out. The 2005 rates remain in place for businesses with gross receipts or gross profits over \$6 million.

Gross receipts are the total sales of a business. The rate for taxing gross receipts, set in 2005, is nine and one half cents (\$0.095) per \$100 of gross receipts. A company's gross

profit is the difference between sales and the company's cost of goods. The tax rate for gross profits is seventy-five cents (\$0.75) per \$100 of gross profits. As a quick example, the \$30,000 price of a car sold is the business's gross receipt. The difference between that \$30,000 and the \$25,000 that the dealer paid for the car, \$5,000, is the gross profit. The net income or net profit is the \$5,000 minus expenses such as salaries, building and lot costs, advertising, etc.

These changes agreed on for the June 2006 special session are intended to provide relief for small businesses. Businesses are expected to save \$20.3 million in taxes from the changes in the gross profits and gross receipts tax calculations.<sup>4</sup> Kentucky businesses have complained that requiring multiple tax calculations is expensive, that businesses who never owed taxes now do, and that the calculations unfairly tax companies such as car dealerships and home building companies that have large gross receipts but small profit margins.

## Conforming Kentucky Tax Law to Federal Tax Law

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The consensus bill before the June 2006 special session will also make certain changes in state tax law to conform to federal tax law. Limited liability corporations will be treated in Kentucky as they are under federal law. The annual cost of this conformity is \$24.5 million in FY 2007 and is projected to grow to \$32.6 million in FY 2010.<sup>5</sup>

## What is Next for Business Taxes in Kentucky?

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There are some calls for further changes in the state's business taxes. Some legislators have left open the door for more changes in the 2007 General Assembly. Some business leaders and others insist that only net profits of businesses should be taxed. Others posit that businesses, like individuals, benefit from the infrastructure and legal systems provided by state government and some minimum tax is fair.

## Citations:

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1. Governor's Communications Office Press Release, "Governor Fletcher Signs Proclamation Calling General Assembly into Special Session," June 22, 2006.
2. Legislative Research Commission, "Display HB 272 with Free Conference Changes," March 2005.
3. "Is Kentucky's Corporate Income Tax High?" Democracy Resource Center, February 5, 2005 and KYA calculations.
4. Fiscal Note for House Bill 1 of the 2006 Extraordinary Session.
5. Fiscal Note for House Bill 1 of the 2006 Extraordinary Session.