Kentucky Chamber
Center for Policy & Research

A GUIDE TO KENTUCKY TAX REFORM

How the Commonwealth Is Strengthening Its Economic Potential Through Pro-Growth Tax Modernization

JANUARY 2025

Tax reform is a journey, not a destination. As economic conditions change, as Kentuckians' preferences change, and as other state tax codes change, Kentucky policymakers need to remain focused on ***ensuring a competitive tax structure in the Commonwealth to support sustainable, long-term economic growth.***

Introduction

In the 2022 legislative session, Kentucky lawmakers took a bold step forward in pursuing pro-growth changes to the state's tax code. With passage of House Bill 8, legislators initiated a process to phase out the state's individual income tax carefully and methodically. This legislation aligns not only with commonsense, pro-growth economic policy but also with the preferences of Kentucky taxpayers, who overwhelmingly support reducing the state's reliance on individual income taxes for funding key government services.

The plan initiated by House Bill 8 is leading to steady progress. Since passage of this legislation, lawmakers have managed to reduce Kentucky's flat individual income tax from 5% to 4% and are likely to continue reducing the rate in upcoming legislative sessions. Meanwhile, Kentucky's economy and state revenues have continued to grow, allowing for historic investments across the state and new opportunities.

To help inform this important work, the Kentucky Chamber Center for Policy and Research has released a range of resources, including two partnership reports with the nonpartisan tax policy think tank, the Tax Foundation. In the summer of 2022, the Center released a key resource specifically for policymakers called "A Guide to House Bill 8." The Center designed this guidebook to help policymakers understand the mechanics of how Kentucky is approaching tax reform and why it is important. This new publication aims to update that guide and provide a broader context for understanding tax reform in Kentucky—both what has already happened and what should happen next.

Some of the key highlights from this guidebook include:

- **An overview of recent economic research and data illustrating how pro-growth tax reform can support Kentucky's economy**
- **An analysis of public opinion data demonstrating Kentuckians' strong support for reducing the state's individual income tax**
- **A brief history of recent tax reform efforts in Kentucky, including an analysis of how House Bill 8 will gradually reduce individual income taxes**
- **Recommendations on how Kentucky lawmakers can continue the critical work of pro-growth state tax reform**

Tax reform is a journey, not a destination. As economic conditions change, as Kentuckians' preferences change, and as other state tax codes change, Kentucky policymakers need to remain focused on ensuring a competitive tax structure in the Commonwealth to support sustainable, long-term economic growth. This new report can serve as an instructive guide to policymakers as they continue this journey and pursue the important work of pro-growth tax reform.

WHY STATE TAX REFORM IS IMPORTANT

Key Takeaways:

- States have wide latitude to design their tax systems in ways they see fit.
- While multiple factors affect a state's economic trajectory, a pro-growth tax code that prioritizes taxing individual consumption and spending instead of taxing production and income can help support economic development and create more employment opportunities for a state's residents.
- State lawmakers across the nation have acknowledged these economic dynamics and are actively working to ensure the competitiveness of their state tax codes.
- A state tax code should align with the preferences of state taxpayers, and Kentuckians overwhelmingly support reducing state taxes on individual income.

States Have Wide Latitude in Designing Their Tax Systems—Why Not Do It Right?

States levy taxes to raise revenues for services deemed important by their residents, such as education, public safety, and economic development. State policymakers are generally free to design their tax systems in ways they see fit. Within parameters outlined in the U.S. Constitution—and as interpreted by federal courts—states can decide what to tax, who to tax, how to tax, and how much to tax within their jurisdictional boundaries. The result of this dynamic is 50 truly unique state tax codes (not to mention thousands of local jurisdictions) with an astonishing array of tax categories, rates, and rules.

The decisions that states make in determining these taxes, rates, and rules can be consequential. In varying degrees, state tax decisions can both positively and negatively affect economic growth and increase or limit opportunities available to a state's residents.

While studying the economic impacts of state tax decisions is tricky because so many other factors are at play, including a state's workforce, infrastructure, and geography, academic research notes that some state tax decisions are better than others. Kentucky policymakers should be keenly aware of the pros and cons of their options and seek out the most economically optimal and efficient policies. Given the freedom that states have to design their tax systems, why not do it right?

What the Research Says

By and large, researchers find that state taxes on production and individual income are more economically disruptive and less efficient than state sales taxes that are neutrally and transparently levied on individual consumption and spending.

For example, the nonpartisan Tax Foundation wrote in its study of Kentucky's tax code in 2021: "All taxes are not created equal. Any tax creates a certain amount of economic drag; this is unavoidable. There is truth to the adage that 'whatever you tax, you get less of' — so it makes sense for policymakers to think carefully about what they choose to tax, and how. Individual income taxes fall on labor; on the margin, they lower the payoff to work, decreasing the supply of labor while increasing its cost. … Consumption taxes are much more economically neutral by comparison, and the economic literature consistently finds that sales taxes are less of an impediment to economic growth or location decisions than are income taxes. … Evidence of the adverse impact of individual income taxes has been documented at the local, state, federal, and even international level."

> *"Researchers find that state taxes on production and individual income are more economically disruptive and less efficient than state sales taxes that are neutrally and transparently levied on individual consumption and spending."*

For a full review of the academic literature in support of these findings, see pages 13-18 of the Tax Foundation's "2025 State Tax Competitiveness Index" and pages 24-27 of the Tax Foundation's 2021 report "Aligning Kentucky's Tax Code for Growth."

While much of the research reviewed by the Tax Foundation focuses on how state tax policy influences business decisions, there is also a growing body of evidence showing how income taxes can affect where taxpayers choose to live and work. This, in turn, affects states' tax bases and economic activity.

A 2017 "American Economic Journal" paper by scholars from the University of Michigan, University of Alabama, and University of California-Riverside studied the fiscal impacts and population effects of states that did and did not adopt income taxes between 1900 and 2010. The study found that states that adopted income taxes after World War II experienced outmigration compared to states without income taxes, which had the effect of limiting the long-term fiscal benefits of imposing incoming taxes. "We show that the introduction of the income tax in the post-World War II era induced significant outmigration to states that did not have the income tax. … We find that middle and high-earning households were the most likely to leave after the income tax was introduced," the study concluded.

Looking closer to home, a comparison of Kentucky and Tennessee can further help illustrate how taxes can impact a state's economic story. Kentucky adopted its modern individual income tax in 1936, while Tennessee never adopted an individual income tax. In 1940, Kentucky and Tennessee had nearly the same size populations at 2.8 million and 2.9 million, respectively. Between 1940 and 2020, Tennessee saw its population grow more than 130%, while Kentucky's population increased 58%. The economic effects of this growth have been significant. Today, Tennessee's economy is almost twice the size of Kentucky's, valued at $523 billion versus $279 billion, and ranked 16th in the nation instead of Kentucky's 29th place ranking.

KENTUCKY

Population: **4.5 MILLION (2020)**

GDP: **$279 BILLION (2023)**

GDP Ranking: **29TH**

TENNESSEE

Population: **6.9 MILLION (2020)**

GDP: **$523 BILLION (2023)**

GDP Ranking: **16TH**

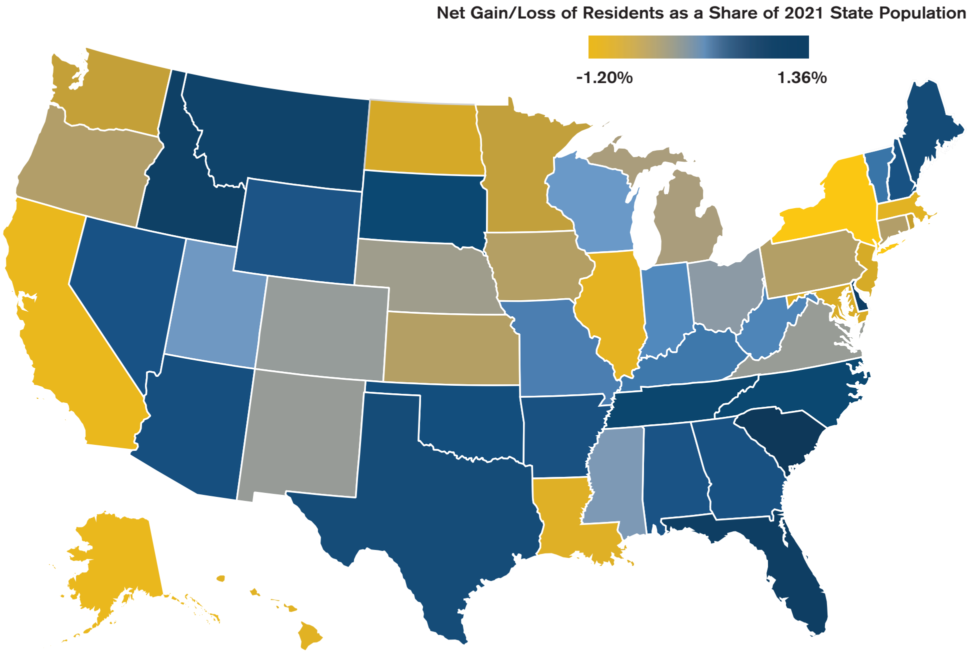
Tennessee's stronger population growth has benefited its residents not only with a thriving economy but also increased political power in Washington, D.C. Due to its larger population, Tennessee has nine congressional districts and 11 votes in the Electoral College. Kentucky has six congressional districts and eight electoral votes. At the time Kentucky first adopted its individual income tax in the 1930s, the Commonwealth had 11 electoral votes as well. Over the next 50 years, that number dwindled down to eight as state population growth stagnated, while Tennessee remained relatively consistent at 11 votes.

In the post-pandemic era, states with no income tax or a flat and low rate have attracted more new residents than states with variable rate structures and high-top rates. According to a Tax Foundation analysis of 2021-2022 IRS data, Americans who moved strongly preferred states with lower income tax burdens.

The implications of one state losing residents to others because of poorly structured tax policy can be costly. In a paper from December 2022, Stanford scholar Joshua Rauh studied the impacts of California losing high-income earners to other states primarily due to its top income tax rate of 13.3%, the highest in the nation. He found that tax-motivated departures among high-earners from California to lower-tax jurisdictions like Nevada, Texas, and Florida reduced taxable income in the state (and increased it in others). Rauh writes, "With high-earning individuals moving out, so too does a large portion of their income. This represents a loss of economic activity and tax revenues. We estimate that in 2019 alone, nearly $30 billion in taxable income was earned by taxpayers who moved out of California in the next year, while just $19 billion was earned by those moving in, resulting in a net outflow of nearly $11 billion that could have been taxed by the state."

Of the 10 states that experienced the largest gains in income taxpayers, 4 do not levy individual income taxes on wage or salary income at all. Additionally, 8 of the top 10 states either forgo individual income taxes on wage and salary income, have a flat income tax, or are moving to a flat income tax. (Tax Foundation, September 2024) Among the 26 states that experienced net inbound migration of income tax filers, only 10 had a top marginal individual income tax rate above the national median, which stood at 5.7% in 2021 (and by now has gone down to 5%). Meanwhile, among the 24 states (and the District of Columbia) that experienced net outbound migration of income tax filers, 15 states and DC had top marginal rates above the median. In aggregate, states with a top marginal rate at or below the 2021 median of 5.7% gained 248,794 net new tax returns (493,662 individuals, including spouses and children). - Tax Foundation

State Population Changes Attributable to Interstate Migration, 2021-2022

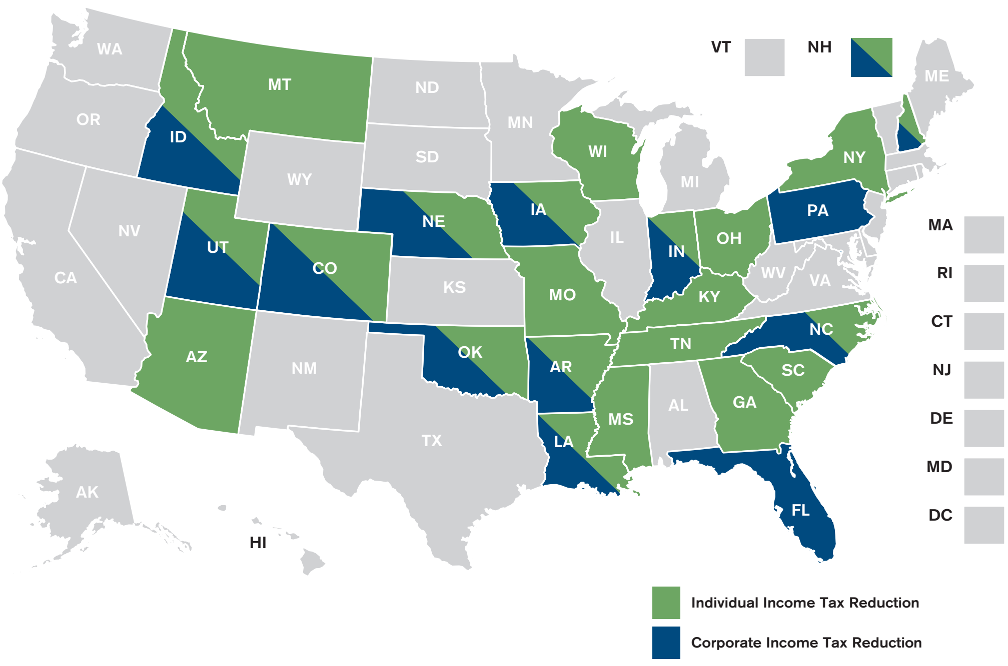


Source: Tax Foundation, IRS, SOI Tax Stats; Census Bureau state population estimates for 2021

States Across the Nation Are Emphasizing Low Taxes on Production and Income

More and more state lawmakers across the country have acknowledged the economic benefits of pro-growth tax reform, and most state legislatures have been actively working to modernize their tax codes with a focus on reducing income taxes. This includes blue and red states. From January 2021 through June 2023, 25 states reduced individual income taxes, while 13 reduced corporate income taxes.

Income Tax Rate Reductions Enacted or Implemented in 2021 and 2022
As of June 7, 2023



Source: Tax Foundation

Kentuckians Prefer a Tax System That Is Less Reliant on Income Taxes

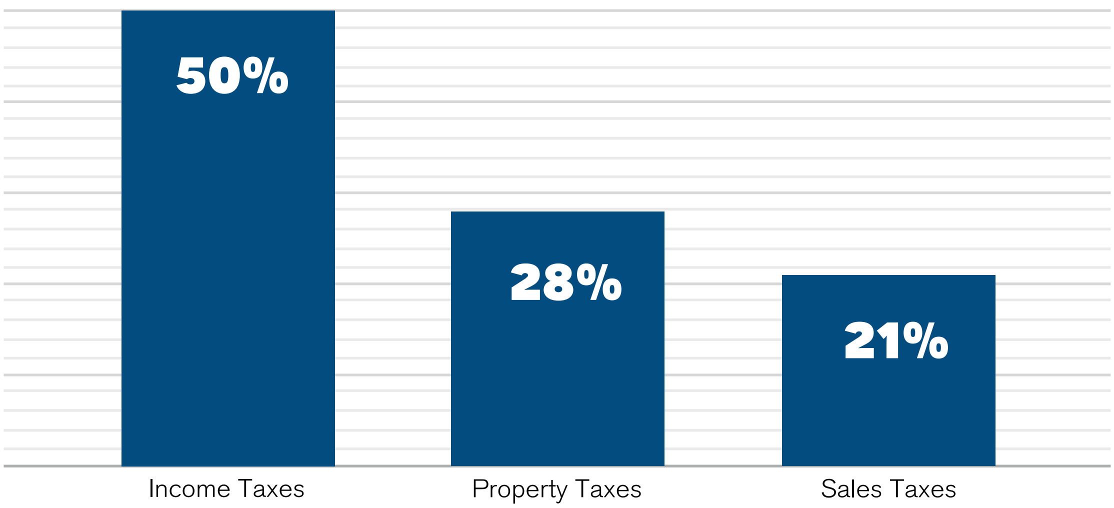
Setting aside the economic arguments for ensuring a pro-growth state tax structure, an equally important argument is that a state's tax system should generally align with what taxpayers prefer—Kentucky taxpayers want a system that is less reliant on income taxes.

In June 2024, the Kentucky Chamber partnered with UpOne Insights to conduct a scientific survey of Kentuckians' views on tax policy. The results demonstrate that Kentuckians strongly prefer a tax system with low or no taxes on individual income.

When asked to consider income taxes, property taxes, and sales taxes and to say which of the three costs them and their families the most, 50% of Kentuckians said income taxes, 28% said property taxes, and only 21% said sales taxes.

Of the following taxes, which one do you feel costs you and your family more?

Kentucky Chamber/UpOne Insights Survey

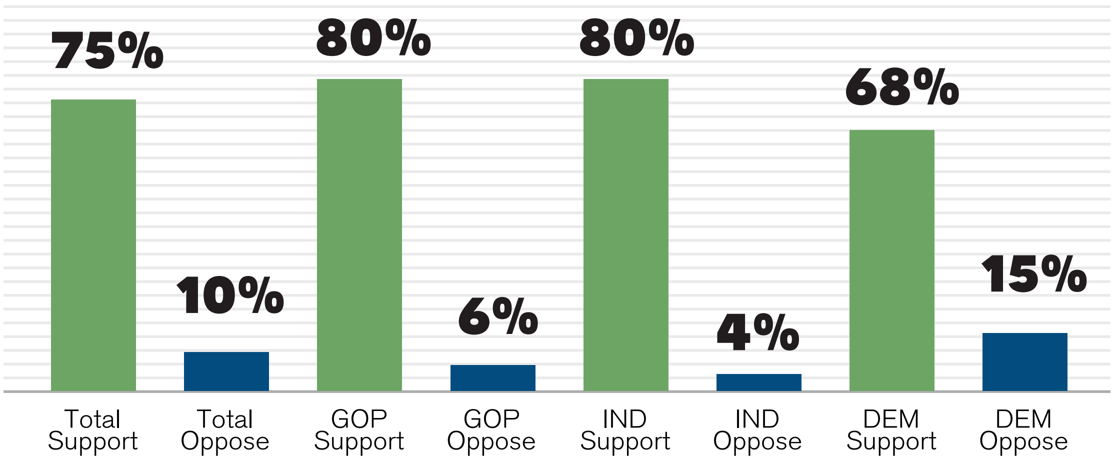


500 registered voters, June 10-13, 2024

When asked about their views on lowering Kentucky's personal income tax, 75% of Kentuckians voiced support with 55% voicing strong support. Only 10% opposed lowering personal income taxes. Strong support was consistent across registered Republicans, Independents, and Democrats in Kentucky.

Would you strongly support, somewhat support, somewhat oppose, or strongly oppose lowering Kentucky's personal income tax?

Kentucky Chamber/UpOne Insights Survey



500 registered voters, June 10-13, 2024

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KENTUCKY TAX REFORM, 2018 TO THE PRESENT

Key Takeaways:

- Kentucky's approach to tax reform has been impactful but also careful and methodical.
- The state has demonstrated forward progress with major pro-growth reform packages in 2018 and 2022.
- While Kentucky has pursued reforms to corporate, sales, and property taxes, a focal point has been phasing out the individual income tax.

While numerous changes to Kentucky's tax code have been made throughout history, reforms implemented in the 2018 and 2022 legislative sessions were watershed moments for the Commonwealth. Two key characteristics of the legislature's approach to tax reform during this period have been a focus on economic competitiveness and implementing reforms carefully and methodically.

The 2018 and 2019 Tax Reform Measures

In the 2018 regular session, legislators passed a major pro-growth tax reform package that the state Department of Revenue called the "most substantial Kentucky tax law changes since 2006." The 2018 reforms included the following elements:

- Replaced Kentucky's variable-rate income tax structures with a flat rate of 5% across the board for individual and corporate income taxes
- Eliminated several individual income tax expenditures to account for a new flat rate of 5% instead of 5.8% or 6% for most taxpayers
- Modernized corporate income taxes with single sales factor apportionment for most corporate taxpayers (instead of three-factor apportionment), implemented market-based sourcing, and implemented unitary combined reporting for most corporate taxpayers
- Aligned key elements of Kentucky's tax code with the federal Tax Cuts and Jobs Act passed by Congress in 2017
- Instituted an income tax credit against Kentucky's property taxes on inventory
- Established rules to formally incorporate online sales into the state's sales tax base in alignment with the 2018 Wayfair Supreme Court decision
- Added new services to the state sales tax base

In 2019, lawmakers passed a follow-up package that refined certain elements of the 2018 package. Together, these legislative efforts brought Kentucky's tax code into the modern era and created better alignment with competitor states. As a reflection of this progress, the reforms of 2018 and 2019 caused the nonpartisan Tax Foundation to update Kentucky's business tax competitiveness from 37th in the nation to 18th in its State Business Tax Climate Index.[1]

KENTUCKY'S RANKING IN TAX FOUNDATION BUSINESS TAX CLIMATE INDEX

2018	2019	2020	2021 & 2022
37TH	20TH	19TH	18TH

1 In 2024, the Tax Foundation changed the methodology of its annual business tax climate index. Consequently, Kentucky's ranking is now different and does not align with previous editions of the index.

House Bill 8 in the 2022 Legislative Session

Kentucky's next major tax reform package came in the 2022 legislative session with House Bill 8. This bill included several changes to state tax policy, including further modernization of the state sales tax base, but the key elements of the bill were a reduction of the individual income tax rate from 5.0% to 4.5% and a formula to guide further reductions in the future.

House Bill 8's emphasis on reducing individual income tax rates aligns well with the economic literature discussed earlier in this report and reduces tax burdens on both individuals and many small business owners who pay their taxes through the individual income tax code as pass-through businesses.

Kentucky's Individual Income Tax Rates

Complex Variable Rate
Income Tax Structure

PRE–2018

2% of the amount of net income **up to $3,000**

3% of the amount of net income **over $3,000 and up to $4,000**

4% of the amount of net income **over $4,000 and up to $5,000**

5% of the amount of net income **over $5,000 and up to $8,000**

5.8% of the amount of net income **over $8,000 and up to $75,000**

6% of the amount of net income **over $75,000**

Simple Flat Rate
Income Tax Structure

2018–2022
A single flat rate of **5%** of net income

2023
A single flat rate of **4.5%** of net income

2024
A single flat rate of **4%** of net income

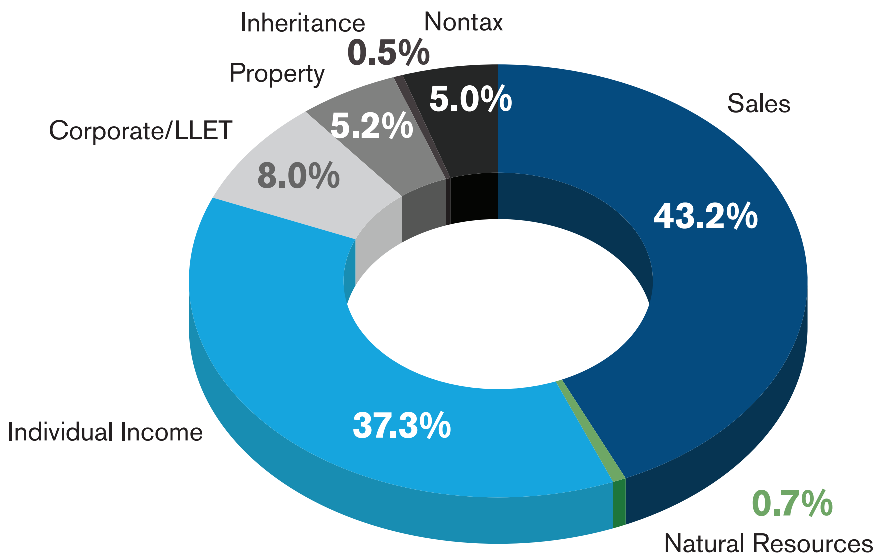
The process for further reducing Kentucky's individual income tax rate in House Bill 8 borrows from a well-established fiscal concept called "revenue triggers." In state tax policy, this term refers to a practice where policymakers set certain fiscal goals for state revenues that "trigger" a reduction to a specific tax, like a rate reduction or other changes. For example, in 2013, North Carolina lawmakers passed legislation to gradually reduce the state's corporate income tax rate based on state revenues hitting specific benchmarks outlined in statute. In the original design of the state's revenue triggers, statute allowed for a one percentage point rate reduction if state revenues met a specific target amount in the next fiscal year. North Carolina has modified its process over the years, but their approach has helped them reduce their corporate income tax rate from 6.9% in 2013 to 2.5% in 2024. Other states have implemented similar structures, including Oklahoma, Missouri, New Hampshire, and Indiana.

The idea behind revenue triggers is that they allow states to reform certain taxes gradually instead of rapidly. This approach can help ensure revenue stability and prevent sudden volatility in state tax receipts. Even if a rate reduction in one tax is offset by base broadening or higher rates for other taxes, it may still make sense to wait and see how revenues fluctuate before implementing tax rate reductions or reforms.

While some may take issue with the gradual approach of revenue triggers, the alternative approach of rapid implementation can backfire. The most well-known example of this dynamic is the tax changes pursued by Kansas in 2012. The state cut taxes dramatically and quickly under the assumption that economic growth would immediately occur and help prop up state revenues. Tax reform can indeed induce economic growth, but it doesn't happen overnight. Instead, reforms lead to growth in the long run. Kansas eventually repealed its changes when state revenues declined, and lawmakers were faced with cutting popular programs and basic services. Revenue triggers could have allowed Kansas to implement reforms more carefully and gradually, allowing policymakers to achieve their intended goals over time.

When it comes to reducing individual income taxes, caution is especially appropriate for Kentucky. While tax reform is helping Kentucky become less reliant on individual income taxes, these revenues still make up a large share of the state's annual tax receipts. In Fiscal Year (FY) 2024, individual income tax revenues made up 37% of total state revenues. A single percentage point reduction equals roughly $1.4 billion. Fully phasing out those revenues will require continued economic progress and growth in other tax categories, especially the sales tax.

Kentucky General Fund, Fiscal Year 2024



Source: *Kentucky Office of State Budget Director*

How House Bill 8 Works

Kentucky's version of revenue triggers focuses on ensuring that the state has a strong savings account and that revenues are sufficiently outpacing appropriations before tax cuts are allowed. The triggers are designed very conservatively. In fact, they serve more as guides than traditional triggers and are referred to in statute as "reduction conditions." Here's how the process works:

By September 1 of every year, KRS 141.020 instructs the Office of State Budget Director (OSBD) to conduct an analysis of state revenues and spending. Specifically, OSBD is to determine:

- If the Budget Reserve Trust Fund balance at the end of the most recent fiscal year is equal to or greater than 10% of General Fund revenues (excluding tobacco funds); and
- If revenues at the end of the most recent fiscal year exceed state General Fund appropriations by an amount equal to a one percentage point reduction in the individual income tax rate. Appropriations exclude continuing appropriations, deposits to the Budget Reserve Trust Fund, lump-sum pension payments, and most appropriations from the Budget Reserve Trust Fund.

• If the answer to both questions is yes, then the General Assembly may act in the next legislative session to implement a half percentage point reduction to the state individual income tax rate. That rate reduction would take effect at the start of the next calendar year following the legislative session in which the vote took place.

Some real-world examples can help illustrate this process further. In August 2022, following passage of House Bill 8 in the 2022 legislative session, the OSBD conducted its instructed analysis for FY2022, which ran from July 1, 2021, to June 30, 2022. First, OSBD determined if the Budget Reserve Trust Balance as of June 30, 2022, was equal to or greater than 10% of state revenues for that year. They determined that the Budget Reserve Trust balance was $2.4 billion, which was 17% of that year's $14.7 billion in revenues. So, the first condition was met. Next, they determined that state General Fund appropriations for that year plus the equivalent of a one percentage point reduction to the individual income tax rate equaled $14.3 billion. Because the state's $14.7 billion in state revenues exceeded this number, the second condition was met. In the 2023 legislative session, lawmakers acted on this information. They voted on and passed House Bill 1, which reduced the individual income tax rate from 4.5% to 4.0%, effective on January 1, 2024.

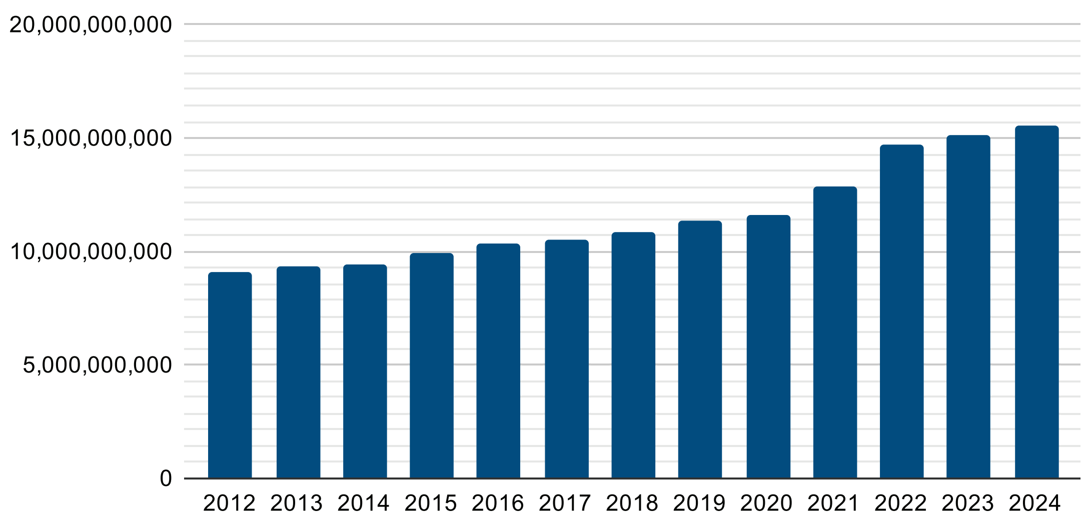
	Variables	FY2022	FY2023	FY2024
Condition 1 The Budget Reserve Trust Fund balance at the end of the most recent fiscal year must be equal to or greater than 10% of General Fund revenues.	Budget Reserve Trust Fund (BRTF) balance	$2,495,652,609	$3,713,518,566	$5,257,619,317
	Revenues	$14,702,460,457	$15,147,665,170	$15,571,256,903
	BRTF balance as a percentage of revenues	17.0%	24.5%	33.8%
	Condition met?	YES	YES	YES
Condition 2 Revenues at the end of the fiscal year must exceed state General Fund appropriations by an amount equal to a one percentage point reduction in the individual income tax rate.	Revenues	$14,702,460,457	$15,147,665,170	$15,571,256,903
	General Fund appropriations	$13,119,092,158	$14,352,274,344	$14,053,628,038
	Equivalent of a one percentage point reduction to the individual income tax rate	$1,209,505,654	$1,230,291,270	$1,366,470,378
	General Fund appropriations + (IIT) individual income tax rate reduction equivalent	$14,328,597,812	$15,582,565,614	$15,420,098,416
	Condition met?	YES	NO	YES

In August 2023, OSBD conducted its annual analysis again. This time, the analysis showed that the state met the Budget Reserve Trust Fund condition but not the revenue and spending condition. Consequently, in the 2024 session, lawmakers did not hold a vote to further reduce the individual income tax rate. In August 2024, however, the annual analysis found that the state met both triggers for Fiscal Year 2024, setting the stage for a vote to reduce the individual income tax rate in the 2025 session.

A unique component to Kentucky's approach to reducing income taxes is that its revenue triggers, or conditions as they are called in state law, serve more as guides than actual triggers. When the conditions are met, a rate reduction is still dependent on a vote by the General Assembly. This provision adds an additional layer of caution and scrutiny and gives lawmakers time to fully assess economic conditions, hear from the public, and understand the revenue impacts.

Kentucky's methodical and careful approach to tax reform is paying off. House Bill 8 alone has reduced individual income tax burdens on taxpaying Kentuckians and small business owners by $1.4 billion per year, and the structure of the Commonwealth's tax code is far more competitive and attractive. This approach has also afforded the state the financial stability to continue making strategic investments and providing services that taxpayers want. As lawmakers have lowered individual income tax rates, Kentucky's tax revenues have continued on an upward trajectory.

Kentucky State General Fund Revenues, Fiscal Year 2012-2024



Source: *Kentucky Office of State Budget Director*

This revenue stability, alongside careful budgeting, has created more funding for services like education, public safety, and economic development and has allowed Kentucky to have a robust Budget Reserve Trust Fund for the first time in recent history. Pew Research Center ranked Kentucky's Budget Reserve Trust Fund in FY2024 as the sixth strongest in the nation and second strongest in the region, with an estimated reserve of $3.7 billion. This fund not only ensures Kentucky is prepared for an economic downturn but also allows for it to make strategic investments and receive investment income. In the 2024 legislative session, for example, lawmakers appropriated $2.7 billion from the Budget Reserve Trust Fund for a range of health care, infrastructure, and education projects. In addition, in FY2024, the Budget Reserve Trust Fund allowed the state to bring in $300 million in investment income.

While there are steps lawmakers should take to continue improving Kentucky's tax code—these are discussed in more detail later in this report—stakeholders should recognize that the state's careful and methodical approach to tax reform is yielding results and keeping the state on a strong fiscal footing.

WHAT POLICYMAKERS SHOULD DO NEXT

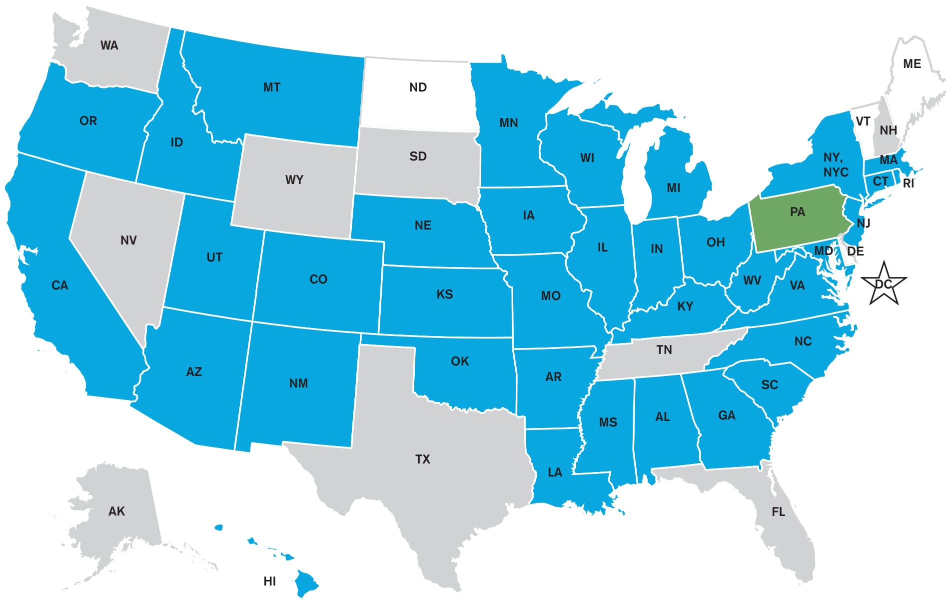
Key Takeaways:

- Kentucky has been consistent in implementing pro-growth reforms since 2018, but so too have other states.
- Lawmakers should continue implementing reforms, including improvements to House Bill 8's reduction conditions, reforming the Limited Liability Entity Tax, improving the state's treatment of business investments, removing business purchases from the state sales tax base, and ensuring a competitive corporate income tax rate.

Continued Forward Progress

A key to policymakers' success in reforming Kentucky's tax code so far has been steady forward progress. Since passage of House Bill 8 in 2022, lawmakers have continued this forward momentum with other tax policies aimed at economic competitiveness. In 2023, legislators implemented a plan to gradually reform property taxes on bourbon barrels. In that same session, they passed legislation to make Kentucky one of 36 states with a pass-through entity tax to help Kentucky business owners reduce their federal income tax liability.

States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax
As of May 14, 2024



36 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted: AL, AR[1], AZ[1], CA, CO[3], CT[4], HI[2], GA[1], IA[1], ID, IL, IN[1], KS[1], KY[1] (& KY) ,LA, MA, MI, MD, MN, MO[1], MS[1], MT[2], NC[1], NE[3], NJ, NM[1], NY, OH[1], OK, OR[1], RI, SC, UT[1], VA, WI, WV[1], and NYC[1]

[1] Effective in 2022
[2] Effective in 2023 or later
[3] Retroactive to 2018
[4] Mandatory 2018-2023, elective starting 2024 As of May 14, 2024

1 state with active proposed PTE tax bills: PA – SB 659 in Senate committee; HR 1584 in House committee

9 states with no owner-level personal income tax on PTE income: AK, FL, NH, NV, SD, TN, TX, WA, WY

4 states with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes: DC, DE, ME, and ND

Source: *AICPA*

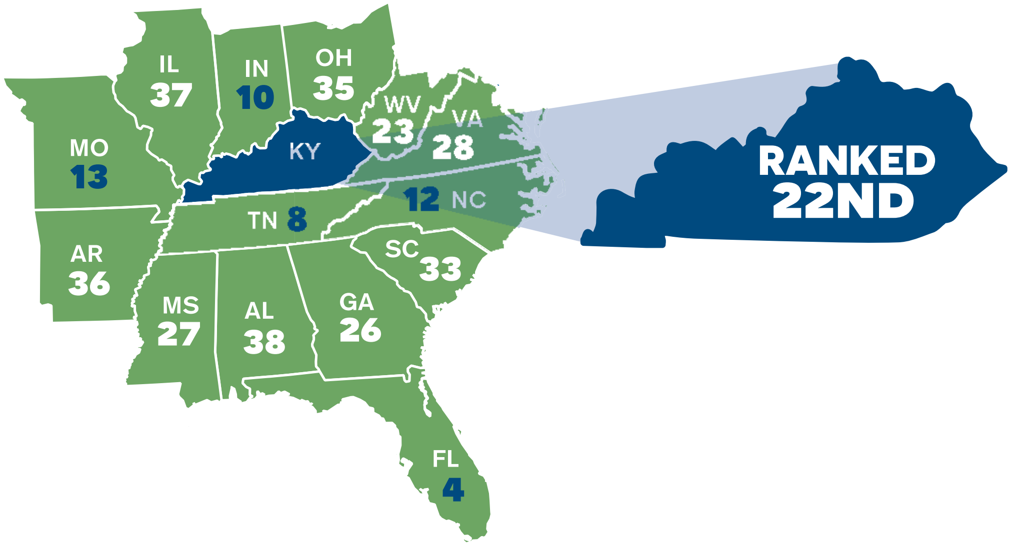
This forward progress is important because, while Kentucky has implemented reforms, so too have other states. For example, in 2022, the combined average individual income tax rate of Kentucky's nearby states, excluding Tennessee, was 5.1%. By 2024, that number had fallen to 4.6%. States that reduced individual income tax rates included Indiana, Missouri, Arkansas, Georgia, North Carolina, West Virginia, and Ohio. Many of these states also implemented pro-growth reforms to other taxes, including sales taxes and corporate taxes.

State	Top Marginal IIT Rate, January 2022	Top Marginal IIT Rate, January 2024
Kentucky	**5**	**4**
Indiana	3.23	3.05
Illinois	4.95	4.95
Missouri	5.4	4.8
Arkansas	5.5	4.4
Alabama	5	5
Georgia	5.75	5.49
North Carolina	4.99	4.5
Virginia	5.75	5.75
West Virginia	6.5	5.12
Ohio	3.99	3.5
Average (excluding KY)	**5.106**	**4.656**

Source: *Tax Foundation*

Tax reform efforts across the country are transforming the landscape of state tax competitiveness. This dynamic is making it even more critical that Kentucky continues its forward momentum to ensure we can compete for business investments and high-skilled workers. In October 2024, the Tax Foundation released its State Tax Competitiveness Index, a successor to its annual State Business Tax Climate Index. The index looks at more than 150 variables and ranks states based on how well their tax codes align with best practices. The index is a good demonstration of how competitive Kentucky's region has become. In the new index, Kentucky ranks 22nd in the nation, while five states in our broader region outrank us and are among the top 15 most competitive state tax climates in the country. These states include Indiana, Tennessee, Missouri, North Carolina, and Florida.

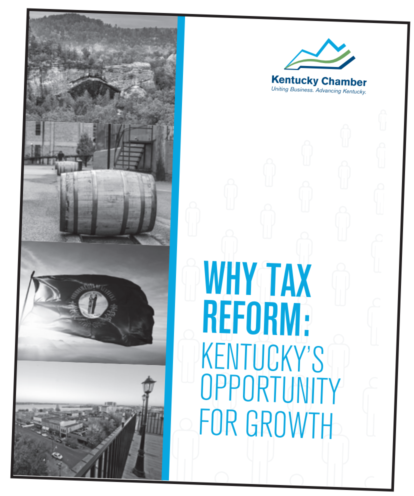
Tax Foundation 2025 State Tax Competitiveness Index

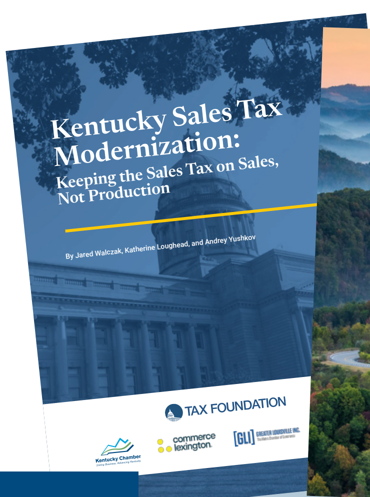


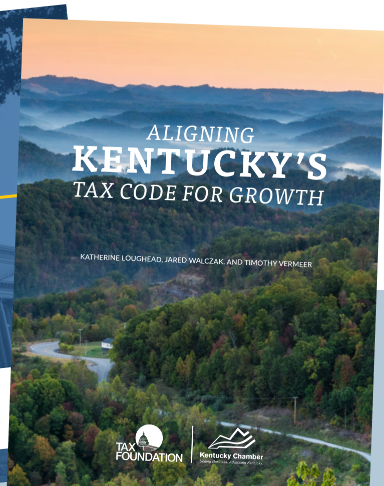
Top Tax Reform Measures to Continue Moving Kentucky Forward

This means that Kentucky cannot afford to rest on its laurels. The state should continue implementing reforms carefully and methodically and should embrace its recent history of continuous improvement and forward progress. This will help ensure Kentucky remains economically competitive, as other states also work to modernize their tax codes and optimize for their own growth.

The Kentucky Chamber has worked to provide a range of resources to assist lawmakers with this work, emphasizing specific policy recommendations that are backed by objective research and data. In 2021, the Chamber partnered with the Tax Foundation to produce a 78-page reform guide titled “Aligning Kentucky’s Tax Code for Growth.” In 2024, the Chamber partnered again with the Tax Foundation to produce another reform guide focused on the sales tax titled “Kentucky Sales Tax Modernization: Keeping the Sales Tax on Sales, Not Production.” In addition, through the Chamber’s Board of Directors and Tax Reform Task Force, the Chamber has leveraged the expertise and perspectives of the state’s top business leaders to identify high-priority reforms in its 2022 publication, “Why Tax Reform: Kentucky’s Opportunity for Growth.”







These are the Chamber’s top tax reform recommendations for policymakers to continue building on the state’s forward momentum. All these recommendations focus on economic competitiveness and align closely with the methodical approach to tax reform that lawmakers have embraced since 2018. Other recommended changes can be read about in the Chamber’s 2025 Legislative Agenda.

Learn More

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Allow for More Incremental Rate Reductions Under the House Bill 8 Formula

Under the current House Bill 8 formula, lawmakers aim for a half percentage point reduction to the individual income tax rate when reduction conditions are met. To ensure continued progress, lawmakers should consider scenarios where smaller rate reductions might be allowed, particularly in instances where the current reductions are not met but are close.

FY2023 is a good example of how this could work. For that fiscal year, the state missed the reduction condition requiring state revenues to exceed appropriations by an amount equivalent to a full one percentage point rate reduction. The total miss was $434 million. In instances like this, lawmakers could consider allowing for a smaller rate reduction. While the one percentage point rate reduction threshold was not met, revenues did surpass appropriations by more than a half percentage point rate reduction equivalent. This could have allowed room for a quarter percentage point rate reduction to have been voted on in the 2024 session. If that had been allowed, Kentucky would have a 3.75% individual income tax rate in 2025 instead of a 4% rate.

Allowing such incremental rate reductions would align with the approaches of other states. Indiana, for example, reduced its individual income tax rate from 3.23% in 2022 to 3.15% in 2023 and 3.05% in 2024. These reductions are small, but they add up over time and demonstrate to out-of-state businesses and high-skilled workers the state's commitment to forward progress.

Reform the Limited Liability Entity Tax

The Limited Liability Entity Tax, or LLET, is an archaic tax on businesses that makes Kentucky an outlier, adds layers of unnecessary complexity, and harms business competitiveness. The LLET applies to a wide range of different businesses, including small businesses, and is a tax on a business's gross receipts—total revenues without accounting for costs or expenses. While once a relatively common tax, most states have repealed gross receipts taxes like the LLET, apart from a small group of states such as Kentucky. The Tax Foundation highlighted the LLET as one of Kentucky's most problematic taxes in its 2021 reform guide.

Based on analysis by the Kentucky Society of Certified Public Accountants in June 2018, the state likely derives minimal benefits from the tax. Because of how the tax is computed, most tax filers subject to the tax pay the minimum LLET amount of $175, causing many of them to spend more on compliance than what they actually remit in tax. In addition, because filers can claim a credit for LLET taxes paid against their income taxes, the net gain to the state may be less than $100 million. The tax creates significant compliance burdens on businesses while yielding only a small benefit to state revenues.

Lawmakers should conduct additional studies of the LLET and consider ways to repeal or reform it. Repealing it could involve replacing lost revenues with other means that are less complex and burdensome for businesses. Short of a full repeal, the Chamber supports reforming the tax by offering more clarity to determine what business expenses qualify as cost of goods sold (COGS) in the LLET gross profits calculation to make it easier for businesses and tax preparers to comply. To simplify compliance and increase fairness, the Chamber supports aligning Kentucky's COGS definition with that of the COGS definition for federal tax purposes. The General Assembly has considered legislative proposals to implement these reforms, such as House Bill 445 in the 2022 session.

Improve Kentucky's Treatment of Business Investments

A key reform recommended by the Tax Foundation's 2022 reform guide for Kentucky involves the tax treatment of business investments. Under current Kentucky law, when a business makes a major capital investment, such as the purchase of new machinery, it is not allowed to fully deduct the cost of that investment in the year in which the cost was incurred. Instead, state law requires that businesses expense these investments over time. This practice restricts the ability of a business to recover its costs efficiently, discourages investments by making them more expensive, and penalizes capital-intensive industries like manufacturing. Lawmakers should position Kentucky's tax code to make the state a magnet for investment by following states like Oklahoma and allowing businesses to fully expense investments in qualified property in the year in which the cost was incurred or, at minimum, allow businesses to expense greater shares of investments up-front than currently permitted by state law.

Most other states treat capital investments by businesses more favorably than Kentucky does. Nearly 40 states, for example, mirror federal provisions established by the Tax Cuts and Jobs Act (TCJA) that allow businesses to deduct up to $1 million in qualified investments in the year in which the expense was incurred. The federal provisions in TCJA are designed primarily to support small and mid-sized businesses. Kentucky, unfortunately, only allows for $100,000 to be deducted instead of the federal standard of $1 million. Similarly, 16 states mirror federal rules allowing 60 percent bonus depreciation (40% as of 2025) for C corporations with qualified investments in short-lived assets like machinery and equipment. Two states mirror this treatment on a more limited basis. Kentucky, however, provides no relief for these types of investments.

To consider how to improve Kentucky's treatment of business investments, lawmakers should explore legislation like House Bill 46 from the 2023 session, which would have significantly improved this aspect of Kentucky's tax code.

Remove Business Purchases from the State Sales Tax Base

Sales taxes are often thought of as taxes paid by individual consumers. Rightly so, since that is exactly how sales taxes should work. Unfortunately, most states allow sales taxes to also fall on what are called intermediate business purchases. In general, these are purchases made by businesses that are part of that business's production process. In Kentucky, in fact, business purchases make up 43% of total state sales tax revenues, according to a 2022 estimate by the Council on State Taxation.

There are multiple problems with including intermediate business purchases in the sales tax base. It leads to tax pyramiding for consumers, reduces tax transparency, and drives up the cost of production for businesses. In 2024, the Tax Foundation published a detailed report highlighting a range of economic downsides caused by including intermediate business purchases in Kentucky's sales tax base.

While it may not be possible to fully remove all intermediate business transactions from the state sales tax base, there are two courses of action that lawmakers should pursue. First, avoid adding any new intermediate business transactions to the sales tax base. While broadening the sales tax base to include new goods and services is sound tax policy, lawmakers should focus on ensuring that the sales tax remains confined to final purchases by consumers. This is what the sales tax was designed to do. Second, lawmakers should consider a systematic approach to gradually remove intermediate business transactions like what Utah has done. Utah has been working to gradually prune these purchases from its sales tax base since 1979, starting with the agricultural industry. This has allowed Utah to ensure that business purchases account for less than 40% of their total state sales tax revenues.

Ensure a Competitive Corporate Income Tax Rate

Kentucky's 2018 and 2019 reforms to its corporate tax code marked significant improvements to the state's overall tax competitiveness. A key change included a flat 5% corporate income tax rate. As the state works to reduce individual income tax rates, attention should also be given to Kentucky's corporate income tax rate, which applied to roughly 13,800 C corporations in 2023.

As noted by the Tax Foundation in its analysis of Kentucky, economists generally view corporate income taxes as one of the least efficient and most economically harmful ways for governments to generate revenues (second only to gross-receipt style taxes like Kentucky's LLET). "In a series of Organization for Economic Co-operation and Development (OECD) working papers, OECD-affiliated economists concluded that corporate income taxes are the most harmful to economic growth, followed by individual income taxes, while consumption and property taxes are less economically damaging," the report states.

In addition, a wide differentiation between corporate income tax rates and individual income tax rates could cause the state to overly favor specific types of business formations and develop a bias against corporate business structures. Non-corporate businesses like partnerships, for example, pay income taxes through the individual income tax code instead of the corporate income tax code. Lawmakers should carefully monitor these dynamics and consider reductions to Kentucky's corporate income tax rate in the future. This would ensure state neutrality when it comes to how it treats different business structures and also ensure continued progress on reducing the negative effects of corporate income taxes.

Monitor Changes at the Federal Level

A final point to consider is the impact of possible federal tax reform in 2025. In 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), which ushered in some of the most significant changes to federal tax policy in a generation. These changes had major impacts on state tax codes, many of which adopt federal tax provisions in their own rules and policies, including Kentucky. Much of TCJA is set to expire in December 2025, putting pressure on Congress to make decisions about extending parts of TCJA and implementing new reform concepts. Kentucky lawmakers will need to monitor these discussions very closely. In general, alignment between state and federal tax policy reduces tax complexity, especially for businesses. In instances where federal tax policy is pro-growth, this federal-state alignment can also enhance a state's economic competitiveness. Lawmakers should consult with tax experts to determine the best course for reacting to federal tax changes and utilize key resources made available by the Kentucky Chamber and partner organizations like the Tax Foundation.

CONCLUSION

As mentioned at the beginning of this guide, tax reform is a journey, not a destination. Kentucky lawmakers have embraced this notion, carefully and methodically pursuing impactful reforms since 2018. Much, of course, remains to be done, including carrying out the important work of reducing individual income taxes through the state's revenue trigger model and reforming other components of the state's tax code. Lawmakers should use this guide not only to understand current structures and past reforms but also to plot out the next destination on their journey to create a truly competitive state tax code that positions the Commonwealth for growth and aligns with the preferences and needs of its residents.

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