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History of the Kentucky Income Tax

By Charles R. Lockyer

Although the colonies resorted to partial income taxes, it was not until the twentieth century that states made serious use of general income taxes. The inadequate state administrative organizations and lack of comparable experience retarded the development of this revenue measure. The Wisconsin income tax of 1911 marked a new era in state income taxation. A most significant feature of this state's law was the adoption of centralized income tax administration. The relatively successful Wisconsin experience, in the light of need for additional tax revenue to supplement the property tax, resulted in the adoption of centrally administered, general coverage income taxes by many other states. Currently, 29 and 32 states impose general individual income taxes and general corporation income taxes respectively.

As parties debated the introduction of state income taxes, they advanced certain opinions concerning the economic burden of state government. For example, property owners contended that income, sales, or other types of taxes would provide relief from the onerous property taxes and thereby establish a comparatively equitable tax system. Representatives of business and wage earners frequently contended that income taxes would constitute special burdens and endanger the development of the state economy. Individuals in Kentucky voiced similar observations as the commonwealth pondered the adoption of an income tax.

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1 Alabama, Arizona, Arkansas, California, Colorado, Delaware, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, Utah, Vermont, Virginia, and Wisconsin impose general individual income taxes. In addition, Ohio, New Hampshire, and Tennessee impose taxes on income from specified intangibles.

2 Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia, and Wisconsin impose general corporation income taxes.
Income taxes in some states encountered serious legal obstacles. Several state courts held such taxes to be repugnant to constitutional provisions, particularly those provisions concerned with uniformity.²

**Movement For Kentucky Income Tax Legislation**

Kentucky enacted a partial income tax in 1867 when the General Assembly imposed a 5 per cent tax on income from United States bonds.³ This tax was one of several partial income taxes that southern and border states enacted in the Civil War era. The Kentucky tax law required the assessors to list income derived from interest on federal obligations and to apply a special five per cent tax. The statute imposed an obligation on the sheriff to collect the tax and specified that the revenue collected was to be placed “on deposit in any bank . . . subject to the future action of the legislature.”⁴ In 1871 the General Assembly transferred such tax receipts to the general fund.⁵ Bond-holders soon contested the constitutionality of the tax. They contended that a tax on the interest was in effect a property tax upon the bond, a federal instrumentality and was an unconstitutional restraint upon federal government’s power to borrow money. The state conceded the invalidity of a state’s power to tax such bonds. The act was short-lived inasmuch as the Court of Appeals ruled that there was no substantial difference between the bond and the interest.⁶ During the life of the law, the state collected a total of $15,814.74 from this source.⁷ This tax was an income tax in name only. The statute diffused the administration of the tax among the various county officials and obviously excluded from taxation the vast portion of income.

Property taxes, fees, and legal licenses constituted the bulk of Kentucky tax revenues from 1792 to the 1930’s. After the end of

³Ky. Acts 1867, c. 1832.
⁴Ibid.
⁵Ky. Acts 1871, c. 1422.
⁷Auditor of Public Accounts, Reports, 1868, p. 20; 1869, p. 14; 1870, p. 10; 1871, p. 10; and 1872, p. 13.
the nineteenth century, the commonwealth resorted to other sources of tax revenue. The state's indiscriminate utilization of other sources resulted in a tax system that was quite inadequate. The difficulties with the unwieldy Kentucky tax system were brought to a head between 1934 and 1936. In 1936 the General Assembly revised the system. Legislation in 1936 that provided for individual and corporation income taxes constituted an important segment of the new financial structure.

Prior to 1936 various individuals and groups of individuals had made attempts to enact a Kentucky income tax. In 1910 Governor Augustus E. Willson noted that "the bulk of taxes will always be paid out of our incomes, no matter on what property laid" and recommended that the state take advantage of the "wave of acclamation for income taxation" by enacting a Kentucky income tax and thereby "pay our debts and raise everybody's salary but those forbidden by the Constitution." The 1910 General Assembly ratified the sixteenth amendment (income tax) to the federal constitution, but no member introduced a state income tax bill as the Governor recommended.

Governor A. O. Stanley, on February 3, 1917, called a special session of the General Assembly for the purpose of providing the state with "a modern, just and efficient system of revenue and taxation." Among the numerous bills before the legislature, Representative W. B. Harvey introduced a corporation income tax bill. The bill, as introduced, provided for a one per cent excise tax on corporation net incomes for the privilege of doing business. It authorized the State Tax Commission to utilize applicable regulations that the Commissioner of Internal Revenue prescribed for federal corporation income tax purposes. It gave corporations the option of filing either a prescribed state tax return or a duplicate of the federal corporation income tax return. It also allocated interstate income according to the ratio of the value of the property and assets located in Kentucky to the total value of property and

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assets of the corporation.11 The bill defined “value” for income tax purposes as the same as the assessed value for property tax purposes.

Legislators proposed several amendments to the original bill. Representative R. B. Hutchcraft, Jr. submitted an amendment which fundamentally changed the bill.12 In lieu of the net income tax, the amendment increased the corporation license tax rate from $0.30 to $0.50 on each $1,000 of capital stock. The General Assembly passed the amendment and enacted the bill in its modified form thereby increasing the tax based on capital stock rather than imposing a corporation net income tax.

The General Assembly of 1922 established the Efficiency Commission of Kentucky13 to make a comprehensive study of the state government. Among other things, it was to “inquire into and report concerning all existing and prospective sources of revenue.”14 The commission’s report considered the desirability of a Kentucky income tax.15 It regarded as highly desirable the progressive elements that an income tax would inject into the Kentucky tax system. It also considered the accumulated experience in the area of income taxation by other states and concluded that the administration of income taxes was of paramount importance in the success or failure of the various state experiments. The commission indicated its lack of confidence in the ability of the Kentucky State Tax Commission to cope with the inevitably complex administrative problems of a general income tax and therefore did not recommend its adoption.16

In the General Assembly of 1926, Representative A. M. Mercer introduced an individual and corporation income tax bill.17 Governor W. J. Fields supported the bill as a means of raising the badly needed revenue for state institutions. The bill reportedly provided for a tax graduated from one to six per cent on individuals and a flat six per cent tax rate on corporations.18 Various

11 The House later amended the allocation formula and provided for the use of property value and business done as allocation factors.
12 Kentucky House Journal, Special Session (1917), pp. 514-520.
14 Id. at sec. 8.
16 Id. at 805.
17 Kentucky House Journal (1926), House Bill 351, I, p. 370.
18 The Courier-Journal (Louisville), February 9, 1926.
organizations mustered considerable opposition against the bill. The opposition attacked the proposed income tax in the press and at hearings on numerous grounds and contended that an income tax would deter industrial development in the state, was universally disapproved, could not be administered by a state, was burdensome to small income groups, was unconstitutional, and was abhorrent to public policy.\textsuperscript{19} The opposition prevailed and the measure was not brought to a vote in the House. The General Assembly also defeated most of the selective sales taxes that the administration advocated.

In an attempt to raise funds for certain state institutions, an unofficial committee of members of the 1930 General Assembly drafted and introduced an income tax bill.\textsuperscript{20} The bill reportedly provided for individual tax rates ranging from one per cent on the first $3,000 of income to five per cent on all income in excess of $9,000.\textsuperscript{21} The measure allowed a $1,000 exemption for single taxpayers, $2,000 exemption for married taxpayers, and a $200 exemption for each dependent. It also imposed a four per cent tax on the net incomes of corporations and earmarked revenue from the tax for specified state institutions and for the general fund.\textsuperscript{22} Supporters of the bill estimated the revenue from the proposed income tax at about four million dollars, although some estimates ran as high as $12 million.

Opposition developed and legislators and interested groups attacked the measure as incapable of being administered, oppressive to industrial and capital growth, onerous to the farmer, economically inapplicable to Kentucky; opponents advanced other arguments similar to those presented in 1926. The press referred to the measure as the "Hargrove Monstrosity." One contention was that the imposition of an income tax would be particularly undesirable in a state tax system in which property taxes were significant. This argument was apparently very influential in de-

\textsuperscript{19} Id., January 14, 1926; February 9, 1926; February 12, 1926; and February 13, 1926.
\textsuperscript{20} Kentucky House Journal (1930), House Bill 576, I, p. 975.
\textsuperscript{21} The Courier-Journal (Louisville), February 19, 1930 and March 4, 1930.
\textsuperscript{22} The bill provided the following earmarking of income tax revenues: 54 per cent to the general fund for debt retirement, 25 per cent to charitable and penal institutions, 6 per cent to the University of Kentucky, 8 per cent to each of the four white normal schools, and 2 per cent to the State Tax Commission for administrative expenses.
feating the proposed tax. The opposition argued that an income
tax, coupled with a property tax, would result in a duplication of
tax burdens because both the property and income derived from
the property would be taxed.\textsuperscript{23} Advocates of the income tax bill
pointed out that they also contemplated a drastic decrease in the
property tax rate. Opponents contended that an income tax would
be acceptable only if the legislature segregated property taxes as
a source of tax revenue for local purposes only. It is interesting
that the constitution prohibits such segregation.\textsuperscript{24} Although the
bill did not come to a vote in the House, the General Assembly
adopted a resolution which established a special legislative com-
mission on taxation.\textsuperscript{26} The General Assembly instructed the com-
mission to study state tax and revenue problems and if necessary
to recommend that the Governor call an extraordinary session to
investigate the present system “and to prepare such new law or
laws on revenue and taxation . . . as they shall deem advisable.”\textsuperscript{28}

At the 1932 General Assembly it was apparent that additional
sources of tax revenue must be forthcoming for the state properly
to finance services at the existing level. The depression greatly
aggravated the state revenue situation. The people elected Ruby
Laffoon as governor on a platform that called for a reduction in
real property taxes. Representative B. F. Shields introduced an
income tax bill.\textsuperscript{27} Provisions of the bill were quite similar to the
1930 bill except that the measure did not earmark proceeds to
various institutions and the 1932 bill provided for tax credits in
lieu of personal income exemptions. Reportedly, Doctor Shields
estimated that the measure would raise from two million dollars to
five million dollars depending upon the phase of the business
cycle.\textsuperscript{28} The General Assembly however devoted most of its at-
tention to an administration-sponsored sales tax bill. The House
passed the sales tax bill, but the Senate Rules Committee did not
report it for a vote. The House did not vote upon the income tax

\textsuperscript{23}This contention is also found in some court decisions which have held that
an income tax is a property tax on the income-producing property and when
coupled with the property tax is double taxation of the income-producing property.
\textsuperscript{24}CONSTITUTION OF KENTUCKY, sec. 171 and Martin v. High Splint Coal Co.,
268 Ky. 11, 103 S.W. 2d 711 (1937).
\textsuperscript{25}Kentucky House Journal (1930), House Resolution 37, III, pp. 3155-3158.
\textsuperscript{26}Id., p. 3157.
\textsuperscript{27}Kentucky House Journal (1932), House Bill 734, II, p. 1262.
\textsuperscript{28}The Courier-Journal (Louisville), February 19, 1932.
measure. Notwithstanding the governor's attempt to decrease expenditures and his vetoing of the property tax cut, the state deficit increased.

During the regular session of the 1934 General Assembly, Representative W. J. Garnett, acting independently of the administration, introduced an income tax bill which provided for a one per cent tax on the first $5,000 of income, two per cent on the next $3,000, and three per cent on all income in excess of $8,000. An exemption of $2,000 was allowed single taxpayers, $3,500 for married taxpayers, and $600 for each dependent. The measure was referred to the Committee on Revenue and Taxation No. 2 which subsequently amended the bill by way of a substitute bill. The House failed to take a vote upon the bill. Representatives W. Y. Handy and K. L. Francis introduced two additional income tax bills. The administration allegedly sponsored the bill introduced by Representative Francis; however Governor Laffoon indicated his desire that the legislature prescribe the type taxes utilized. The 1934 General Assembly enacted only one tax measure of general significance, the Gaines-Gilbert Act that materially reduced the property tax rate relating to revenue and taxation. The General Assembly approved a resolution which established the Legislative Interim Committee to study the state fiscal situation and recommend suitable tax sources. It specified that the committee should ascertain the desirability of an income tax as well as draft such a bill. The Interim Committee concluded that the state needed an annual increment in tax revenues of more than $10 million even if expenditures were reduced to what appeared to be the minimum. It recommended, after considering various tax revenue combinations, a combination of a three per cent sales tax and an individual and corporation income tax. Members of the General Assembly sought the counsel of Professor James W. Martin of the University of Kentucky for purposes of drafting the proposed income tax bill. The draft of the income tax provided for a personal tax rate graduated from two per cent to five per cent and a three per cent tax for corporations. The bill provided exemptions of $1,000, $2,000, and $400 for single

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30 Id. (1934), House Bills 476 and 515, I, pp. 837 and 891.
taxpayers, married taxpayers, and dependents respectively. The general tenor of the bill was quite similar to provisions of the federal income tax law. It provided for the use of tangible property and sales as factors for the purpose of allocating interstate corporation income. The Interim Committee estimated that the proposed personal and corporation income tax would yield approximately $2.5 million per year. In commenting upon this type tax the committee stated that the proposed income tax would take the place of the tax “reduction that the wealthy land owners ... investors in real estate for rental purposes, and corporations of the State received as a result of the Gaines-Gilbert bill.” The committee also stated: “Your committee further finds that this tax can be properly administered at a very economical cost, and finds from expressions from other states, that unless an income tax is made reasonable, it will drive from Kentucky many of its wealthy citizens and big corporations who [sic], in many other ways contribute to the support of this State. ...”

The minority report likewise recommended an income tax although it opposed certain other conclusions. Governor Laffoon voiced unequivocal concurrence with the committee’s recommendations. The Kentucky Farm Bureau Federation and the Delegate Assembly of the Kentucky Education Association adopted resolutions favorable to the income and sales taxes.

This income tax bill was the first bill introduced in the House. Many individuals predicted its early passage. Although the recent reduction in property tax rates doubtless removed some of the objections advanced against previous income tax bills, opposition soon developed. Spokesmen from urban areas opposed the measure on the ground that such a tax would unduly burden their constituents. As usual, opponents of the measure attacked the bill on the grounds that it would stifle capital and industrial growth and because greater economy in government would ameliorate the need for such revenue. The opposition of legislators representing urban areas was manifest in a concerted refusal to sign the Interim Committee’s report as well as taking other

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3 Ibid.
4 Id. at 90.
6 Kentucky House Journal, Extra Session (1934), House Bill 1, pp. 28 ff.
actions designed to retard the passage or to weaken provisions of the measure. For example, Representative Robert E. Beatty proposed doubling such exemptions. Professor James W. Martin estimated such an amendment would decrease income tax revenue by approximately 50 per cent. The House passed the bill, with modifications principally in phraseology, on May 16, 1934 by a favorable vote of 85 to eight after it had rejected the amendment to increase exemptions.

Opposition in the Senate proved more effective than in the House. Former Mayor of Louisville, William B. Harrison, contended that a "state income tax would hamper efforts to obtain outside business . . . in . . . Kentucky." Mayor Neville Miller of Louisville objected to the lack of a provision exempting municipal bonds. The Louisville Board of Trade urged its defeat and alleged that the income tax would result in double taxation, would be suicidal to impose with a franchise tax, and contended that income tax administration was "very difficult and uncertain." The Kentucky Education Association, the Superintendent of Public Instruction, and other organizations and individuals including the Governor urged its passage. It was not until the final days of the session that the Senate brought the measure to a vote. The Senate finally rejected the bill by a vote of 18 for the bill to 13 against it (20 votes necessary for passage) after it had previously approved some 14 amendments which rendered the bill ineffective for most practical purposes. The Senate passed the sales tax, likewise a controversial measure, on the third ballot after it had rejected the income tax bill.

The sales tax proved to be quite unpopular. Within two years organized opposition vigorously demanded its repeal. The gubernatorial campaign of 1935 centered about this issue. The voters elected Governor Albert B. Chandler, then Lieutenant Governor and prominent anti-sales tax leader. The General Assembly of 1936 immediately repealed the sales tax law by votes of 99 to one in the House and 36 to 0 in the Senate. The general pattern of legislative action in 1936 appeared to be: repeal of certain laws

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77 *The Courier-Journal* (Louisville), May 16, 1934.
78 Id., May 29, 1934.
such as the sales tax, comprehensive reorganization of state government including finance administration, passage of a general appropriation bill, and finally the adoption of a state tax system which was reasonably adequate and equitable. Such comprehensive legislation obviously necessitated well planned legislative proposals, a product of considerable study. The Governor established the Governor's Reorganization Commission for the purpose, among other things, of designing a tax system for Kentucky. Several similar commissions or committees functioned during prior administrations; however there were several fundamental differences in the 1936 commission work. The prescribed tax system constituted a basic change in the Kentucky tax policy. That is, the commission placed much emphasis upon the idea of taxing according to ability rather than merely recommending the modification or adoption of a property, sales, or other specific tax primarily because of immediate revenue productivity. In addition to modifying the underlying theory of the state tax system, the 1936 commission supplemented their recommendations with well planned proposals.

Professor James W. Martin made an extensive analysis of the Kentucky tax revenue system in the early 1930's which proved to be very influential in the revenue legislation of 1936. Indeed, the press suggested that the governor had adopted the study as the administration's tax program. Although the study recommended revision of the property tax, a proposal in which the governor failed to concur, possibly due to prior commitments, the administration did adopt most of the other suggestions that the study advanced. This was particularly true with respect to taxes that the state should adopt for additional tax revenue. The Governor's Reorganization Commission made extensive use of this study in its efforts to devise a suitable tax system for the commonwealth. After the property tax proposal, Professor Martin recommended, in order of importance, the adoption of a personal income tax, a

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42 See Howard Henderson, "From the State Capitol," The Courier-Journal (Louisville), March 1, 1936.
corporation income tax, a revised inheritance tax, and various selective excise taxes on specified commodities or services as additional sources of state tax revenue.\textsuperscript{43}

The method of enacting the 1936 tax revenue legislation was also quite different from previous occasions. With comprehensive revenue proposals and supplementary data available, the legislature was able to evaluate proposals otherwise obscured by lack of planning and of relevant data. Another important characteristic of the 1936 legislation was the participation of the Chairman of the State Tax Commission in hearings affecting important tax legislation. Although the administration voiced no objection to amendments proposed in both houses, the administration sponsored a definite tax legislative program.

The income tax bill reflected the efforts of the Governor’s Reorganization Commission and other sources of assistance, including that of the State Tax Commission. The authors of the Kentucky income tax bill relied heavily upon the Model Act of the National Tax Association and the federal income tax law. The 1936 income tax measure was substantially the same bill that the Interim Committee sponsored in 1934.\textsuperscript{44} Under the 1936 bill, gross income included all income from property and services except capital gains from assets held two years or more. It excluded specified insurance payments,\textsuperscript{45} interest on federal obligations, and salaries of federal officials or employees. The bill allowed deductions for expenses and amounts paid in securing taxable income, taxes,\textsuperscript{46} losses,\textsuperscript{47} bad debts, repairs, insurance premiums, depreciation on income-producing assets, dividends on state and national bonds, and contributions.\textsuperscript{48}

\textsuperscript{43}Martin, op. cit., p. 28.
\textsuperscript{44}See Kentucky House Journal, Extra Session (Revenue) (1936), pp. 200 ff. for text of the proposed income tax as introduced in the House.
\textsuperscript{45}The bill excluded life insurance proceeds paid by reason of death, annuity, endowment and insurance payments not in excess of premiums paid; it also excluded accident and health insurance payments and workmen’s compensation from gross income.
\textsuperscript{46}The bill limited the deduction for taxes to property, poll, and corporation franchise taxes paid to Kentucky or its political and taxing subdivisions.
\textsuperscript{47}The bill provided for a deduction for losses not compensated for by insurance if incurred in a trade or business transaction to secure profit subject to tax, and casualty losses not connected with a trade or business. It allowed nonresidents a deduction for casualty losses, not compensated for by insurance, on property having a permanent situs in Kentucky.
\textsuperscript{48}The bill restricted the contribution or gift deduction to amounts paid for public, religious, charitable, scientific, literary, educational and veterans organiza-
tax statute permitted exemptions deductible from the first bracket of income of $1,000 for single taxpayers, $2,000 for married taxpayers, and $300 for each dependent. The measure provided for a tax of two per cent on the first $3,000 of taxable income, three per cent on the next $1,000, four per cent on the next $1,000, and five per cent on all taxable income in excess of $5,000. It provided for a four per cent tax on all taxable income of corporations. It provided for the allocation of certain types of corporation income unconnected with the business to Kentucky and other states according to the source of such income. Business done (gross receipts) and tangible property provided the basis for allocating business income of manufacturing or selling concerns from interstate sources. Income derived from two or more states of other types of corporations was to be allocated according to rules promulgated by the Department of Revenue.

The House committee promptly returned the income tax bill with a favorable expression of opinion. The committee of the whole conducted open hearings in which a lengthy discussion ensued. The committee paid considerable attention to the possible effects that a state income tax would have on business and business location. The opposition from urban areas alleged that such a tax would adversely affect business. Various individuals indicated that available data and experience in other states did not support such a contention. The House passed the bill after one unsuccessful vote in which 17 members were absent or did not vote.

Both houses amended the bill. Most amendments tended to decrease the revenue productivity of the measure. The House of Representatives passed an amendment that exempted farmers' and other mutual insurance companies from the tax. It amended the exemption for married taxpayers to apply to the heads of families and increased the amount of the exemption from $2,000 to $2,500. An amendment authorized public utilities to allocate interstate income according to accounting techniques prescribed by the Federal Communications Commission or Interstate Com-

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46 Id., p. 346.
merce Commission if such accounting methods reflected income on a state basis. As suggested by municipal officials, the House amended the bill to provide for the exemption of income from obligations of Kentucky, its political subdivisions, and municipalities or instrumentalities thereof.\(^5\) Other House amendments pertained primarily to changes in terminology.

Senatorial hearings considered the effect of income taxes on industrial growth and development. Spokesmen from urban areas objected to the tax primarily because of the adverse effect on business and onerous effect on employees and wage earners.\(^5\) Several opponents suggested the enactment of a sales tax in lieu of the income tax. As in the case of several previous income tax bill hearings, supporters of the bill reiterated that available data did not substantiate the conclusion that a state income tax retards industrial growth and development. Indeed, the secretary of the Kentucky Farm Bureau Federation pointed out that Wisconsin, with an income tax, experienced the greatest relative industrial growth in the nation over the previous 25 years.\(^5\) The Senate further modified the bill by adding 14 amendments\(^5\) which increased the list of allowable deductions to include federal income taxes as well as all interest payments except those attributable to nontaxable income. The Senate also increased the exemption for dependents from $300 to $400. It made an allowance for depletion of natural resources on a basis substantially similar to the federal law and exempted from taxation all payments to veterans or dependents as a result of war service. The Senate added military organizations (including the Kentucky national guard) to the list of organizations for which taxpayers may claim a deduction for contributions. The Senate changed the effective date of the tax from the date of enactment to January 1, 1936, and thereby imposed the tax on the full calendar year of 1936 rather than only the latter months of 1936. Other senatorial amendments were primarily concerned with changes in terminology. The Senate failed by one vote to pass a proposed amendment that would have exempted intercorporate dividends. However it confirmed

\(^{5}\) Id., p. 347.
\(^{6}\) C. W. Bailey, The Courier-Journal (Louisville), April 21, 1936.
\(^{7}\) Id., April 25, 1936.
\(^{8}\) Kentucky Senate Journal, Revenue and Taxation Session (1936), pp. 155 ff.
the measure by a vote of 21 to 12, and it returned the bill to the House for approval or rejection. Upon receipt of the measure the House concurred with Senate amendments and passed the bill by a vote of 65 to 21. On May 8, 1936, Governor A. B. Chandler signed the measure, the final step of enacting, thereby making Kentucky the 29th state imposing a general individual income tax and the 30th state imposing a general corporation income tax. Reportedly, Professor Martin estimated that the income tax based on the income level of 1935 would produce about three million dollars in tax revenue per year.

In addition to a state income tax the General Assembly also imposed excise taxes on the sale or the use of spirits and wine, motor vehicles, cigarettes, motor fuel, admissions to amusements, and services of public utilities. The 1936 legislature also increased revenue productivity aspects of the death and chain store taxes. It made tax reforms and drastically revised the tax administration organization and thereby greatly improved the Kentucky tax system. The 1936 tax legislation placed much more emphasis upon the taxpayer's ability than was the case under the earlier tax system. The resulting system also proved to be adequate to avoid the deficits, previously plaguing the commonwealth at the average rate of about two million dollars per year.

AMENDMENTS TO THE KENTUCKY INCOME TAX STATUTE

From 1936 to 1954, the General Assembly has passed amendments to the state income tax laws during every regular session. The amendments have affected many different aspects of the income tax law as well as the same aspect several times. For example, the General Assembly in 1946, 1950, 1952, and 1954 modified provisions related to the personal and dependency allowances. The following discussion groups the amendments according to those primarily affecting taxable income, personal and dependency allowances, rates, and returns and payments. The federal income

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55 Id., p. 165.
57 The Courier-Journal (Louisville), April 14, 1936.
58 The Kentucky General Assembly on January 19, 1937, repealed those excises imposed on such items as candy, chewing gum, cosmetics, fountain syrup, ice cream, nuts, and soft drinks (Ky. Acts 1936-1937 Fourth Extra Session, c. 19). This tax repeal was effective April 17, 1937.
tax law has had a particularly significant influence upon amendments to the state income tax law.

Amendments Affecting Taxable Income

From 1936 to 1954 the state law defined gross income and authorized specific deductions for the purpose of ascertaining net income. During this period the legislature made several changes in the gross income concept and in deductions. It patterned several of these modifications after the federal law but usually with significant time lags. The 1952 legislation offers an example of the difficulty of amending the state law to conform with the federal definition. The 1952 legislature intended conformity with the federal with respect to gross income of decedents. As a result of 1951 federal legislation which was not reflected in the 1952 state amendment, the General Assembly, in effect, departed from the federal practice.

The 1954 General Assembly eliminated an independent definition of gross, net, and adjusted gross income concepts and adopted by reference the federal concepts contained in the Internal Revenue Code on January 1, 1954. For state tax purposes certain departures from the federal concept are made. Individual taxpayers exclude income constitutionally exempt from state taxation, dividend income from Kentucky banks and trust companies, and “net operating loss deduction”; they include interest from obligations of states (other than Kentucky) or their political subdivisions and federal income tax refunds; and they deduct federal income

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69 The legislature changed the provisions applicable to the inclusion of dividends in 1940 (Ky. Acts 1940, c. 179), in 1948 (Ky. Acts 1948, c. 93), and in 1952 (Ky. Acts 1952, c. 226). In 1948, it also altered the taxability of alimony and capital gains (Ky. Acts 1948, c. 93). It modified in 1950 the gross income concept applicable to trusts (Ky. Acts 1950, c. 172) and in 1952 the gross income concept applicable to decedents (Ky. Acts 1952, c. 194).

60 The 1946 legislature gave individual taxpayers the option of using a standard deduction in lieu of itemizing deductions (Ky. Acts 1946, c. 234). In 1948 the General Assembly made changes including an allowance for deductions by corporations, an unlimited allowance for certain individuals, a redefinition of recipients to which taxpayers may contribute and claim a deduction, and an allowance for medical expenses (Ky. Acts 1948, c. 24 and 93). In 1952 it adopted by reference the federal depletion allowance, specified that taxpayers take deductions on the same accounting basis as they computed taxable income, provided for deduction by decedents on the same basis as in the federal law, specified that taxpayers not engaged in a trade or business may deduct ordinary and necessary expenses incurred in the production of taxable income, and specified that state income taxes were not deductible (Ky. Acts 1952, c. 194).

taxes. Net income for corporation and individual taxpayers is the same except that individuals may deduct state income taxes which is denied corporation taxpayers.

The 1954 amendment includes capital gains from the sale or exchange of capital assets within the purview of taxable income which the state law previously ignored. It also permits a deduction for state and local taxes such as income, sales, and gasoline taxes. The amendment attempts to introduce an element of simplicity by allowing state income taxpayers to base their liability on the same tax base as the federal. The extent to which Congress modifies the income concepts after January 1, 1954 will reduce the intended simplicity. In the light of a biennial state legislature and past experience, it does not appear that the state will modify the state law to secure continuing conformity with the federal.

An important aspect in determining taxable income of corporations deriving income in two or more states is the method of assigning and allocating income to the various states. In 1950 the General Assembly added the pay roll factor to the allocation formula. The Kentucky formula consisting of property, gross receipts (sales), and pay roll factors is in general agreement with recommendations of several study groups concerned with this problem. The amendment also provided for separate accounting if the taxpayer shows the department that separate accounting indicates actual income derived from Kentucky. Under the 1954 amendment, taxpayers might use separate accounting only if "the department determines . . . that the actual amount of net business income attributable to Kentucky is determined by separate accounting." The 1954 amendment makes no special provision for the use of separate accounting by utilities maintaining accounting records according to standard classification of accounts of the Federal Communication Commission or the Interstate Commerce Commission.


Although the three-factor formula is most common among states, there is wide variation with respect to definition of the factors.
64 Ky. Acts 1954, c. 79.
The problem of ascertaining taxable income of an affiliated corporation is in some respects economically similar to the problem of determining taxable income of a corporation that derives income from two or more states. That is, one may calculate income of a geographical or legal segment of an economic unit only with spurious accuracy unless one gives adequate consideration to the income of the entire economic unit. Under the allocation formula, the law imputes a portion of the multistate income to operations in a single state. An apportionment among the separate corporations of consolidated income provides a theoretically sound approach to the problem of imposing the tax on income of a segment of an economic unit. The 1954 legislature indicated an awareness of the problem but probably fell short of providing an adequate solution. The amendment specifies that "The department shall permit (sic) or require any parent corporation or subsidiary... to file a consolidated return... whenever it finds that the inter-corporate transactions of the related group tend to reduce the net income... below the amount that would probably result if... not a member of the related group." It also defined a parent corporation as one that controlled "either directly or indirectly 90 per cent or more of the voting stock of another corporation." The fact that the law limited the use of a consolidated return to instances in which net income would be increased and to those corporations owning 90 per cent of voting stock suggests the need for further legislation in this area.

Amendments Affecting Personal and Dependency Allowances

Since 1936 the Kentucky income tax law allowed income exemptions deductible from the first bracket or brackets of income of $1,000, $2,500, and $400 for single, married or head of family taxpayers, and each dependent respectively. The 1946 General Assembly changed these allowances from income exemptions to tax credits and implemented the short-form tax return. The significance of the amendment is primarily in the form of the allowance rather than the amount of reduced tax liability.

\[\text{Ibid.}\quad \text{\textsuperscript{5} Ibid.}\]

\[\text{\textsuperscript{65} The 1946 amendment did not alter the personal allowance for single or married taxpayers. The $840 dependency exemption in the first bracket equaled an $8 tax credit. Prior to 1946 the law allowed tax liability reductions of $58, $69, or $81 to married taxpayers with one, two, or three dependents respectively. The}\]
In order that the income tax might temporarily produce more revenue, the 1950 General Assembly reduced the amount of the tax credit for married or head of family taxpayers from $50 to $40.68 Under the 1950 amendment, the reduction in tax credits was effective for a temporary two year period but was made permanent by the 1952 General Assembly.69 The 1954 legislature awarded additional tax credits for an aged or blind taxpayer and for his spouse.70 It also granted credits of $2 and $10 for specified fiduciaries and estates respectively.

Amendments Affecting Tax Rates

Although alterations in the tax rate structure may constitute a most important method of varying the revenue productivity, the legislature has changed the basic rate structure but once. In 1950 the General Assembly increased the corporation tax rate from four to 4.5 per cent and increased the individual tax rate from five to six per cent on taxable incomes of $8,000 or more. The 1950 rate increase was temporary; the 1952 General Assembly made it permanent.

Amendments Affecting Returns and Payments

The 1946 General Assembly made extensive modifications toward simplification by the introduction of the short-form tax return, the collateral concepts of adjusted gross income and standard deduction, and the optional tax tables.71 The Kentucky legislature patterned much of the tax simplification after the federal law. In 1954 the legislature extended the use of the optional tax table to individuals whose adjusted gross income does not exceed $8,000.72

Another simplifying 1946 Kentucky amendment eliminated the requirement that the taxpayer must have all income tax returns notarized.73 In lieu of verification before a notary, the amendment specified that the individual must sign all tax returns

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70 Ky. Acts 1954, c. 79.  
"by a written declaration that it is made under the penalties of perjury."\(^7^4\)

The 1948 legislation strengthened provisions pertaining to the time periods in which the department must audit returns and assess additional taxes.\(^7^5\) It extended the period from three to four years.\(^7^6\) The 1952 General Assembly provided that the four-year period in which the department may make additional assessments would begin on the due date rather than date of filing for all returns filed before the date due. The 1948 amendment also authorized the department to assess additional taxes any time within six years after the taxpayer filed or should have filed if the taxpayer filed an incomplete return or omitted more than 25 per cent of properly includable income. The amendment limited the period in which the department may refund taxes outlined in section 135.580 of the Kentucky Revised Statutes to four years after the date the taxpayer paid such taxes to the state treasury.\(^7^7\)

The 1938 legislature gave taxpayers the option of discharging tax liabilities in three equal installments.\(^7^8\) The 1942 and 1952 General Assemblies gave members of the armed forces the right to defer payment of state income taxes.\(^7^9\) In 1954 the General Assembly provided for a current collection program for the individual income tax. Under the revision, residents and non-residents may come within the purview of withholding and estimated tax payment provisions. The amendment also withdrew the installment provision and specified that all liabilities are payable at the time fixed for filing returns. In anticipation of the numerous refunds resulting from the current collection program, the legislature simplified the refunding process. The adoption of a current collection program and change in net income concept probably constitute the most significant of all the state income tax amendments.

\(^7^5\) Ky. Acts 1948, c. 93, sec. 7.
\(^7^6\) Ky. Rev. Stat. sec. 141.210 (1953). If the date of filing was after the due date as a result of delinquency or an extension, the limitation then extends to four years from the time the return was filed.
\(^7^7\) Ky. Acts 1948, c. 93, sec. 10.
\(^7^8\) Ky. Acts 1938, c. 25. In 1952 the General Assembly limited installment payments to those taxpayers with $30 or more of tax liability (Ky. Acts 1952, c. 194).
The 1950 legislation modified the penalty provisions.\textsuperscript{50} Previously, the law imposed a mandatory penalty of 10 per cent of the tax due, with a $10 minimum on all taxpayers that failed to file a return when due.\textsuperscript{81} The statute authorized the department, in cases in which the taxpayer failed to file a return, to estimate from available data the net income of the taxpayer and to assess a tax liability not in excess of twice the amount of taxes payable on such estimated net income. The 1950 legislation retained the department’s discretionary authority to estimate net or adjusted net income\textsuperscript{2} and to affix a tax liability not in excess of twice the amount due on such estimated income. In addition, the law allowed the department to fix a penalty not in excess of 25 per cent of such tax. The amendment imposed a penalty of five per cent of the deficiency if the taxpayer failed to file a return not accompanied with an intent to defraud. The amendment applied a similar penalty of 50 per cent in the event any portion of the deficiency was due to fraud with intent to evade the tax. The conviction of such criminal act carried a fine of not less than $500 nor more than $5,000, or imprisonment for not less than six months\textsuperscript{83} nor more than five years, or both. Thus, the 1950 legislation tempered the mandatory penalties while strengthening those of a discretionary nature. In 1954 the legislature implemented the current collection program by providing penalties for non-compliance by taxpayers and withholding agents.\textsuperscript{84}

\textsuperscript{50} Ky. Acts 1950, c. 189, secs. 3 and 4.
\textsuperscript{81} That is, returns due before March 25, 1950. The 1950 legislation was effective on all returns or reports due on or after March 25, 1950.
\textsuperscript{2} The 1950-1954 amendments used the term “adjusted net income.” This term presumably is synonymous to “adjusted gross income” found elsewhere in the law.
\textsuperscript{83} Changed in 1954 to 12 months (Ky. Acts 1954, c. 79).
\textsuperscript{84} Ibid.