SALT Alert! 2018-04: Kentucky: Major Tax Reforms Enacted

After a tumultuous last few days of the legislative session, major tax changes have been enacted—and more may be enacted—in Kentucky. On Friday April 13, 2018, lawmakers cast the necessary votes to override the Governor's veto of House Bill 366—a bill that includes numerous tax changes. Shortly after, lawmakers passed another bill, House Bill 487, making additional revisions. At this juncture, Governor Bevin has not yet signed House Bill 487. However, collectively, these bills reduce the top corporate and individual income tax rates, make significant changes to Kentucky's corporate income tax regime, expand the sales and use tax base, adopt economic nexus sales and use tax standards, and update the state's conformity to the Internal Revenue Code to capture tax reform.

IRC Conformity

Under enacted House Bill 366, for tax years beginning on or after January 1, 2018, the definition of Internal Revenue Code means the Internal Revenue Code in effect on December 31, 2017, exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect on December 31, 2017 that would otherwise terminate. Thus, the version of the Code to which Kentucky now conforms generally includes the provisions in Public Law 115-97 (i.e., the Tax Cuts and Jobs Act). However, the bill does not specifically address many key corporate tax reform changes individually.

Allowed Deductions

House Bill 366 creates a new section of Kentucky law providing that deductions allowed shall be limited to amounts directly or indirectly allocable to income subject to taxation under Chapter 141 (Income Taxes). A deduction directly or indirectly allocable to income that is exempt from taxation or not otherwise taxed under Kentucky law shall not be allowed. This new statutory section applies to taxable years beginning on or after January 1, 2018. These provisions aren’t new. Kentucky had similar provisions in its prior law. However, these might be more relevant post-federal tax reform given the new deductions allowed under IRC sections 250 and 965(c).

Corporate and Individual Rate Reduction/Addback of Section 199A Deduction

Under prior law, the highest individual and corporate income tax rate was six percent (imposed on net income over $8,000 for individuals and over $100,000 for corporations). Under House Bill 366, a flat five percent tax rate is applied to the taxable net income of individuals and corporations effective for tax years beginning on or after January 1, 2018.
House Bill 487 would provide that, in computing the net income of taxpayers other than corporations, a taxpayer would be required to add back the amount deducted under IRC section 199A effective for tax years beginning on or after January 1, 2018.

**Apportionment Changes**

House Bill 366 makes numerous changes to Kentucky’s allocation and apportionment provisions, including redefining certain key terms. One of these changes is that the term “business income” is replaced with “apportionable income” and the definition is expanded to capture all income that is apportionable under the U.S. Constitution. It also includes any income that would be allocable to Kentucky under the U.S. Constitution, but that is apportioned rather than allocated under Kentucky law. The term “sales” is replaced with “receipts” and “receipts” now means all gross receipts of the taxpayer that are not allocated and are received from transactions and activity in the regular course of the taxpayer’s trade or business. Receipts from hedging transactions and the maturity, redemption, sale, exchange, loan or other disposition of cash or securities are specifically excluded from the definition of “receipts.”

Under previous law, corporations apportioned their income to Kentucky using a three-factor, double-weighted sales factor formula. Under the revised law, all apportionable income, other than income of financial organizations and public service companies, is apportioned to Kentucky using a single-receipts factor formula.

Under prior law, receipts from sales of other than tangible personal property were sourced using the income-producing activity test. House Bill 366 provides that receipts from sales other than sales of tangible personal property are sourced to Kentucky if the taxpayer’s market for the sale is in the state. Specific rules determine when a taxpayer’s market for a sale will be considered in Kentucky. For example:

- In the case of a sale, rental, lease, or license of real property, if and to the extent the property is located in Kentucky.
- In the case of a rental, lease, or license of tangible personal property, if and to the extent the property is located in Kentucky.
- In the case of a sale of a service, if and to the extent the service is delivered to a location in Kentucky.
- In the case of a rental, lease, or license of intangible property, if and to the extent the intangible property is used in Kentucky (intangible property utilized in marketing a good or service to a customer is used in Kentucky if that good or service is purchased by a Kentucky consumer). Receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property are treated as receipts from the rental, lease, or licensing of the intangible property.
- In the case of a sale of intangible property, if and to the extent that the intangible property is used in Kentucky (where the property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, the intangible property is used in Kentucky if the geographic area includes all or a part of the state).

Any sale of intangible property not described in the statute is excluded from the numerator and denominator of the receipts factor. Likewise, if the taxpayer is not taxable in a state to which a receipt is assigned, or the state of assignment cannot be determined or reasonably approximated, that receipt will be eliminated from the denominator of the receipts factor entirely.

House Bill 366 also addresses alternative apportionment. Notably, the bill makes clear that the party (the Department or the taxpayer) that seeks to utilize a different apportionment method to effectuate an equitable allocation and apportionment of the taxpayer’s income must provide by clear and convincing evidence that the statutory provisions do not fairly represent the extent of the taxpayer’s business activity in Kentucky and that the chosen alternative (separate accounting, one or more additional factors or “any other method”) is reasonable. Furthermore, if the Department requires use of a different method, it cannot impose civil or criminal penalties
with reference to any tax due that is attributable to the taxpayer’s reasonable reliance on the statutory allocation and apportionment provisions. A taxpayer that receives permission to use a different, reasonable method shall not have that permission revoked unless there has been a material change in circumstances or the taxpayer materially misrepresented the facts upon which the Department allowed use of the alternative method.

The Department is also given explicit permission to promulgate regulations under the Department’s alternative apportionment authority for taxpayers engaged in particular industries or that have engaged in particular transactions. These regulations must be applied uniformly.

All the apportionment changes described above are effective for taxable years beginning on or after January 1, 2018.

House Bill 487 would make additional apportionment changes for certain types of companies. Notably, an exception from the single-sales factor apportionment and market-based sourcing requirements would be allowed for a “provider” of “communications services,” “cable services” or “internet access.” In other words, these “providers” would use the same apportionment and sourcing provisions that were in effect before House Bill 366. House Bill 487 would also create exceptions for transportation companies and freight forwarders, as these entities would continue to apportion their income using revenue passenger miles for transportation revenues and miles operated by the affiliated airline for freight forwarding revenues. Also, the law would revert to how it operated before House Bill 366 and once again allow corporations to elect to apportion business income from the sale of management, distribution, or administration services to or on behalf of regulated investment companies based on the extent that shareholders are domiciled in Kentucky.

**Unitary Combined Filing**

Effective for tax years beginning on or after January 1, 2019, House Bill 487 would require members of a unitary business group to file a combined report or make an election to file a consolidated return with all affiliated group members. Under current law, combined returns under the unitary business concept are not allowed, and a mandatory nexus-consolidated return can be filed only if the parent entity has Kentucky nexus. This nexus-consolidated return includes only members of the group with Kentucky nexus.

Under House Bill 487, the combined report would include the entire apportionment factors and income of (1) any members incorporated or formed in the U.S. and (2) any members doing business in a “tax haven.” The bill sets forth criteria, rather than a list of countries, for determining what is and is not a tax haven. Also included are a portion of the factors and income of a member that earns more than 20 percent of its income directly or indirectly from intangible property or service-related activities that are deductible against the apportionable income of the other members of the group. House Bill 487 sets forth extensive rules for determining the total income of the combined group, the apportionable income of the group, a taxpayer member’s share of apportionable income, and a taxpayer member’s share of tax. It also defines “unitary business” quite broadly, but does not include a specific stock ownership percentage for determining unity.

If an election is made to file a consolidated return, that return must include all corporations that are members of the federal affiliated group (regardless of nexus). “Affiliated group” means the group as defined under IRC section 1504(a). However, an affiliated group can file a Kentucky consolidated return whether or not it files a federal consolidated return. The election to file a consolidated return is binding on both the department and the affiliated group for 96 months.

**Administrative Changes**

House Bill 366 prohibits the Department from entering into contingent fee arrangements for the purposes of auditing a taxpayer’s books and records or collecting a tax from the taxpayer. With respect to tax assessment notices, for assessments issued on or after July 1, 2018, a taxpayer now has 60 (rather than 45) days from the date of the notice to protest the assessment in
writing. The bill also allows taxpayers to appeal an order sustaining a tax assessment to any
court without paying the tax assessment in full. Finally, the bill changes the timeframe for
submitting the final determination of any federal audit to the Department to within 90 days of
the conclusion of the federal audit, rather than 30 days.

**Sales and Use Tax Base Expansion**

House Bill 366 expands the sales tax base to capture certain services not previously subject to
tax, including:

- Landscaping services (including snow plowing or removal services)
- Janitorial services (including commercial cleaning services)
- Small animal veterinary services (excluding certain animals that are commonly considered
  livestock)
- Pet care services
- Industrial laundry services (including industrial uniform supply services and industrial mat
  and rug supply services)
- Non-coin operated laundry and dry cleaning services
- Linen supply services (including table and bed linen supply services)
- Indoor skin tanning services
- Non-medical diet and weight reducing services
- Limousine services if a driver is provided, and
- Extended warranty services

The tax base expansion applies to transactions occurring on or after July 1, 2018.

House Bill 366 also adopts a new, broad definition of the term “admissions” and specifically
enumerates certain activities as taxable “admissions,” such as admissions to fitness and
recreational sports centers, public and private golf courses, and health spas.

House Bill 366 defines “extended warranty services” as services provided
through a service contract agreement in which the purchaser agrees to pay compensation for the contract and
the provider agrees to repair, replace, support, or maintain tangible personal property or digital
property, if the service contract agreement is sold on or after July 1, 2018 (the date extended
warranty services become subject to tax) and the property at issue in the agreement is subject
to tax.

Further expanding the Kentucky sales tax base, the term “gross receipts” or “sales price” is
redefined to include the amount charged for labor or services rendered in installing or applying
any tangible personal property, digital property, or service sold. Previously, these amounts were
specifically excluded from the definition of gross receipts or sales price.

If enacted, House Bill 487 would exclude from tax gross receipts derived from charges for labor
or services to apply, install, repair or maintain tangible personal property directly used in
manufacturing or an industrial processing process, if the charges for labor or services were
separately stated on the invoice, bill of sale, or similar document given to purchaser. It was
reported that this provision is intended to fix the inadvertent taxation of services involving
manufacturing and processing equipment under the revised definition of “gross receipts” or
“sales price” included in House Bill 366. As noted above, the revised definition in HB 366
specifically includes charges for labor or services rendered in installing or applying tangible
personal property.

House Bill 487 would also largely reorganize the state’s manufacturing and industrial
processing exemption and would exclude from the definition of “prewritten computer software,”
any portion of prewritten computer software that is modified or enhanced to the specifications
of a specific purchaser if there is a reasonable, separately stated charge for the modification or
enhancement.
Economic Nexus for Remote Retailers

Applicable to transactions occurring on or after July 1, 2018, House Bill 366 amends the definition of “retailer engaged in business in this state” to include a remote retailer selling tangible personal property or digital property delivered or transferred electronically to a purchaser in Kentucky if:

1. The remote retailer sold tangible personal property or digital property that was delivered or transferred electronically to a purchaser in Kentucky in 200 or more separate transactions in the previous calendar year or the current calendar year; or
2. The remote retailer's gross receipts derived from the sale of tangible personal property or digital property delivered or transferred electronically to a purchaser in Kentucky the previous calendar year or current calendar exceeds $100,000.

A “remote retailer” is defined as a retailer with no physical presence in Kentucky and does not include a marketplace facilitator or a referrer (as those terms are defined). Importantly, the bill does not appear to impose any duties on marketplace facilitators or referrers, and they may be defined solely for purposes of excluding them from the definition of remote retailer.

Property Taxes

House Bill 487 would exempt from state and local ad valorem taxes computer software, except prewritten computer software, for assessment dates beginning on or after January 1, 2019.

Contacts

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