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Kentucky General Assembly Passes $395-500 Million Tax Increase
(Detailed analysis of Ky. H.B. 366 and H.B. 487 (2018))

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On April 2, 2018, the General Assembly adopted a free conference committee's compromise report for H.B. 366 which includes substantial changes to the state's tax code. Those changes are estimated to raise nearly $500 million over the state's 2019-2020 biennium. The Governor vetoed the bill on April 9. The Kentucky House and Kentucky Senate overrode the Governor's veto on April 13.

On April 14, the General Assembly adopted H.B. 487. As amended in the Senate, H.B 487 includes the entirety of H.B. 366 with additional changes and technical corrections. H.B. 487's changes are estimated to reduce the additional taxes raised over the state's 2019-202 biennium to approximately $396 million. The Governor has ten days (excluding Sundays) to veto H.B. 487. Because the General Assembly has adjourned, any gubernatorial veto cannot be overridden by the legislature.

H.B. 366[1] and H.B. 487[2] make a number of changes to Kentucky's income taxes, sales and use taxes and tobacco taxes as well as reforms aimed at simplifying compliance with and administration of Kentucky's tax statutes. Many of the bill's changes have special effective dates. Otherwise, the bills have emergency clauses and take effect immediately upon enactment. (See H.B. 366, sec. 147; H.B. 487, sec. 162). ***H.B. 366 is now law. H.B. 487 will become law in ten days unless vetoed by the Governor.***

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[1] The text of H.B. 366 as adopted by the General Assembly on April 2 can be viewed at the following address: http://www.lrc.ky.gov/recorddocuments/bill/18RS/HB366/bill.pdf

[2] The text of H.B. 487 as adopted by the General Assembly on April 14 can be viewed at the following address: http://www.lrc.ky.gov/recorddocuments/bill/18RS/HB487/bill.pdf

The Legislative Research Commission has scored H.B. 366 in it is original form and as changed by H.B. 487 as raising the following new revenue over the 2019-2020 biennium:

	H.B. 366	**H.B. 487**
	Biennium 2019-20	**Biennium 2019-20**
Sales and Use Tax	+436.3 MM	+430.5 MM
Corporate Income Tax	-80.0 MM	-80.0 MM
Individual Income Tax	- 114.1 MM	-205.8 MM
Tobacco Taxes	+244.7 MM	+ 251.1 MM
Suspension of Tax Incentives	+ 0.0 MM	+ 0.0 MM
KY-CPA Proposals	+ 0.0 MM	+ 0.0 MM
Repeal of Incentives	+ 0.0 MM	+ 0.0 MM
Total General Fund Impact	**+ 486.9 MM**	**+ 395.8 MM**

A review of the significant tax changes made by these two bills follows.

A. Sales and Use Tax

Kentucky currently imposes a sales tax on the retail sale of tangible personal property and digital property and the furnishing of a limited number of services in the state. The tax is imposed at 6% of the "gross receipts" derived from the sale or services furnished. The current services subject to the sales tax are the furnishing of transient accommodation rentals, sewers services, sale of admissions, prepaid calling service and prepaid wireless calling service, communications services and certain natural gas transportation or distribution services. As a backstop, Kentucky imposes a use tax on the use, storage or consumption in the state of tangible personal property and digital property the purchase of which was not subject to the sales tax. The use tax is imposed at 6% of the "sales price" of the property. Kentucky's use tax does not apply to services.

H.B. 366 amends some of the existing categories of taxable services, adds some additional categories, extends the sales and use tax to labor charges relating to taxable property, and makes adjustments to address a potential change in the law that would allow Kentucky to impose tax on out-of-state retailers. Each of these changes is effective for transactions occurring on or after July 1, 2018 and is discussed below. (H.B. 366, sec. 143). H.B. 487 makes some definitional clarifications to the sales and use tax, exempts manufacturers and processors from sales and use tax on their labor charges relating to taxable property, and limits the sales and use tax energy exemption.

1. Sales tax on admissions extended to facilities and participatory events

Kentucky currently imposes sales tax on admissions. Taxable admissions do not include charges paid for the privilege of using the facilities or participating in the event or activity. See

Revenue Regulation 103 KAR 28:010, § 2(1*); J. Sutter's Mill, Inc. v. Revenue Cabinet*, 793 S.W.2d 838 (Ky. App. 1990); *Spotlight Miniature Golf v. Dept. of Revenue*, 279 S.W.2d 795 (Ky. 1955) (construing the former KRS 138.010 and 138.020 admissions tax). For example, charges for the following are not taxable admissions: (i) amusement park ride charges; (ii) bowling fees; (iii) fishing or picknicking fees; (iv) golf, greens fees or driving range fees; (iv) miniature golf fees; (v) skating fees; (vi) skiing charges; or (vii) swimming fees. 103 KAR 28:010, § 5. Charges to attend instructional seminars, conferences or workshops also are not taxable admissions where the primary intent of the program is for education rather than entertainment. Id. at § 3(1).

H.B. 366 adds a definition of "admissions" and extends taxable admissions to fees paid for "the privilege of using facilities or participating in an event or activity." (H.B. 366, sec. 36, amending KRS 139.010). The bill expressly makes fees paid for the following subject to the sales tax, regardless of whether the fee is paid per use or in any other form including but not limited to an initiation fee, monthly fee, membership fee, or combination thereof: (i) bowling centers; (ii) skating rinks; (iii) health spas; (iv) swimming pools; (v) tennis courts; (vi) weight training facilities; (vii) fitness and recreational sports centers; and (viii) golf courses, both public and private. H.B. 366 does not define any of these new categories of taxable admissions, leaving the scope of these categories to be clarified by regulation or the courts. (Id.)

2. Sales Tax on Transient Accommodation Rentals Extended to Campsite Rentals

Kentucky currently imposes sales tax on the rental of any room or rooms, lodgings, or accommodations furnished by any hotel, motel, inn, tourist camp, tourism cabin, or any other place in which rooms, lodgings, or accommodations are regularly furnished to transients for a consideration. Tax does not apply to rooms, lodgings, or accommodations supplied for a continuous period of thirty days or more to a person.

H.B. 366 clarifies that sales tax applies to the rental of campsites furnished by any campgrounds, recreational parks or any other place in which campsites are regularly furnished to transients for a consideration. Tax does not apply to campsites supplied for a continuous period of thirty days or more to a person. (H.B. 366, sec. 37, amending KRS 139.200).

3. Sales and Use Taxes Imposed on Labor or Services Installing or Applying Taxable Property or Services

Kentucky currently excludes from taxable “gross receipts” and “sales price” the amount charged for labor or services rendered in installing or applying the tangible personal property, digital property, or service sold if the amount charges is separately stated on the invoice to the purchaser. In repair transactions, charges for labor of repair, reconditioning, installation and other services are not subject to the sales and use taxes if they are separately stated on the invoice from the price of the parts and materials furnished in connection with the repair work. See Revenue Regulation 103 KAR 27:150.

H.B. 366 repeals this exclusion and specifically includes in taxable “gross receipts” and “sales price” the amount charged for labor or services rendered in installing or applying the tangible personal property, digital property, or services sold. Where taxable property is sold or taxable services or furnished, these additional labor or service charges will be subject to the sales and use taxes. (H.B. 366, sec. 36, amending KRS 139.010). If the underlying property or service is not taxable, the associated labor or service charges will not be subject to tax.

The sales tax is tied to taxable “gross receipts” and the use tax is tied to the taxable “sales price.” This change imposes the sales tax on the labor component of otherwise taxable sales of tangible personal property and digital property and otherwise taxable furnishing of services. It imposes the use tax on the labor component of otherwise taxable purchases of tangible personal property and digital property to the use tax.

H.B. 487 amends KRS 139.470 to exempt from the sales and use taxes “gross receipts derived from charges for labor or services to apply install, repair, or maintain tangible personal property directly used in manufacturing or industrial processing process, and that is not otherwise exempt [under the exemption for raw materials, industrial supplies and industrial tools] or [the exemption for machinery for new and expanded industry], if the charges for labor or services are separately stated on the invoice, bill of sale, or similar document given to [the] purchaser.” (H.B. 487, sec. 121, amending KRS 139.470).

4. Sales Tax Imposed on Ten New Classes of Services

H.B. 366 imposes the Kentucky sales tax on ten new classes of services. (H.B. 366, sec. 37, amending KRS 139.200). The bill does not define any of these new classes, leaving their scope to be clarified by administrative regulation or the courts. The new taxable classes are as follows:

"**Landscaping services**" which specifically includes but is not limited to the following: (i) lawn care and maintenance services; (ii) tree trimming, pruning, or removal services; (iii) landscape design or installation services; (iv) landscape care and maintenance services; and (v) snow plowing or removal services.

"**Janitorial services**" which specifically includes but is not limited to residential and commercial cleaning services, and carpet, upholstery, and window cleaning services.

"**Small animal veterinary services**" which specifically excludes veterinary services for equine, cattle, swine, sheep, goats, llamas, alpacas, ratite birds, buffalo and cervids.

"**Pet care services**" which specifically includes but is not limited to grooming and boarding services, pet sitting services, and pet obedience training services.

"**Industrial laundry services**" which specifically includes but is not limited to industrial uniform supply services, protective apparel supply services, and industrial mat and rug supply services.

"**Non-coin-operated laundry and dry cleaning services**."

"**Linen supply services**" which specifically includes but is not limited to table and bed linen supply services and nonindustrial uniform supply services.

"**Indoor skin tanning services**" which specifically includes but is not limited to tanning booth or tanning bed services and spray tanning services.

"**Non-medical diet and weight reducing services**."

"**Limousine services**" if a driver is a provider.

H.B. 366 does not impose the use tax on these services.

5. Sales and Use Tax Imposed on Extended Warranty Services

Kentucky currently does not tax parts utilized in the repair of equipment under an original warranty. The value of the original warranty and any parts later provided under that warranty are considered to be reflected in the original selling price of the warranted product. The repairer is not subject to tax on the purchase or use of those parts because those parts are considered to be resold when the warranted product is originally sold. See 103 KAR 28:060(1).

Kentucky currently does not tax the sale of service, maintenance and extended warranties. A separate purchase by a customer of an extended warranty is not subject to sales and use tax at the time of the sale because there is no exchange of tangible personal property. However, the seller or other party providing the extended warranty service must pay sales or use tax on the cost of tangible personal property used to fulfill the terms of the extended warranty. See Id. at (2).

H.B. 366 imposes the sales and use tax on extended warranty services. The sales tax is amended to apply to the furnishing of extended warranty services. (H.B. 366, secs. 37 and 47, amending KRS 139.200 and 139.550). The use tax is amended to apply to the storage, use or other consumption in Kentucky of extended warranty services. (H.B. 366, secs. 36, 45 and 48, amending KRS 139.010, 139.510 and 139.700)). To prevent circumvention of the tax, H.B. 366 also amends the definition of a taxable "use" to include the exercise of any right or power to benefit from extended warranty services. (Id. at secs. 40, and 41, amending KRS 139.310 and 139.330). Out-of-state retailers of extended warranty services are required to register and collect use tax on their sales of such services. (Id. at secs. 42 and 43, amending KRS 139.340 and 139.390).

"Extended warranty services" is defined to mean services provided through a service agreement between the contract provider and the purchaser where 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 according to the terms of the contract if: (a) the service contract is sold or purchased on or after July 1, 2018; and (b) the tangible personal property or digital property for which the service contract agreement is provided is subject to sales or use tax or the motor vehicle usage tax. (H.B. 366, sec. 36, amending KRS 139.010).

It is unclear whether retailers of extended warranty services must pay sales tax on parts purchased and later provided as part of those warranty services. H.B. 366 does not amend Kentucky's resale exemption. The Kentucky courts have held that the purchase of tangible personal property consumed in providing taxable services does not qualify for the resale exemption. See *Ky. Bd. of Tax Appeals v. Brown Hotel Co.*, 528 S.W.2d 715 (Ky. App. 1975).

6. Definitional Changes to the Manufacturing Exemptions

Kentucky currently exempts from the sales and use taxes sales and purchases of "machinery for new and expanded industry," raw materials and certain other tangible personal property used in the manufacturing or industrial processing.

Raw materials, industrial tools and industrial supplies. KRS 139.470(10) currently exempts the purchase and sale of raw materials, industrial tools, industrial supplies, raw materials which become a part of industrial supplies or industrial tools and certain other tangible personal property sold or purchased "to be used in the **manufacturing** or

industrial processing of tangible personal property at a plant facility and which will be for sale." As to industrial tools, industrial supplies, and raw materials for such tools and supplies, the tangible personal property must be "**directly used in manufacturing or industrial processing**." Id. at (10)(a)2.

Machinery for new and expanded industry. KRS 139.480(10) currently exempts from the sales and use tax sales and purchases of machinery for new and expanded industry. "Machinery for new and expanded industry" currently is defined as machinery: (a) used directly in a manufacturing or processing production process; (b) which is incorporated for the first time into a plant facility established in this state; and (c) which, subject to certain exceptions, does not replace machinery in the plant facility. KRS 139.010(15). The statutes currently provide that "processing production" shall include "the processing packaging of raw materials, in process materials, and finished products; the processing and packaging of farm and dairy products for sale; and the extraction of minerals, ores, coal, clay, stone, and natural gas." Id.

Current law provides that "[t]he manufacturing or processing production process commences with the movement of raw materials from storage into a continuous, unbroken, integrated process and ends when the product being manufactured is packaged and ready for sale." (current KRS 139.010(16), defining "manufacturing").

H.B. 487 changes. H.B. 487 adopts new definitions related to the manufacturing sales and use tax exemptions.

H.B. 487 removes all references to "processing production" in the sales and use tax exemption statutes and replaces them with the term "industrial processing." H.B. 487 defines "industrial processing" to include: (a) refining; (b) extraction of minerals, ores, coal, clay, stone, petroleum, or natural gas; (c) mining, quarrying, fabricating, and industrial assembly; (d) the processing and packaging of raw materials, in-process materials, and finished products; and (e) the processing and packaging of farm and dairy products for sale. (H.B. 487, sec. 36, amending KRS 139.010). The new definition clarifies that that the extraction and refining of petroleum constitute "industrial processing" that qualifies for the sales and use tax manufacturing exemptions.

H.B. 487 defines "directly used in the manufacturing or industrial processing process" to mean "the process within a plant facility that commences with the movement of raw materials from storage into a continuous, unbroken, integrated process and ends when the finished product is packaged and ready for sale." (Id. at sec. 36, amending KRS 139.010). As a conforming change, the bill removes the nearly identical existing language in the current definition of "manufacturing" that explains when the manufacturing and processing production processes begin and end (quoted above). This new definition fails to define when something is "directly used" in these processes.

H.B. 487 cleans up the language in KRS 139.470 exempting manufacturers' and industrial processors' raw materials, industrial supplies and industrial tools and makes conforming changes to reference "industrial processing." (H.B. 487, sec. 121, amending KRS 139.470).

As previously noted, H.B. 487 amends KRS 139.470 to exempt from the sales and use taxes "gross receipts derived from charges for labor or services to apply install, repair, or maintain tangible personal property directly used in manufacturing or industrial processing process, and that is not otherwise exempt [under the exemption for raw materials, industrial supplies and industrial tools] or [the exemption for machinery for new and expanded industry], if the charges for labor or services are separately stated on the invoice, bill of sale, or similar document given to [the] purchaser." (H.B. 487, sec. 121, amending KRS 139.470).

7. Changes to the Sales and Use Tax Energy Exemption

Kentucky currently exempts from the sales and use taxes the sale and purchase of energy and energy-producing fuels used in manufacturing, processing, mining or refining to the extent the cost of the energy or energy-producing fuels exceed three percent (3%) of the user's cost production (the "Energy Exemption"). Cost of production for purposes of the Energy Exemption is computed on the basis of "plant facilities" which means all permanent structures affixed to real property at one location. KRS 139.480(3).

Kentucky school districts are authorized to impose a utility gross receipts license tax for schools ("UGRLT") of up to three percent (3%) of the gross receipts derived from furnishing utility services in the school district. See KRS 160.613(1). Kentucky currently exempts from UGRLT amounts received for furnishing energy or energy-producing fuels, used in the course of manufacturing, processing, mining, or refining to the extent the cost of the energy or energy producing fuels used exceeds three percent (3%) of the cost of production. Id. The energy exemption under the UGRLT is very similar to the sales and use tax Energy Exemption.

In *Logan Aluminum, Inc. v. Revenue Cabinet*, KBTA Order No. K-14952 (1993), the Kentucky Board of Tax Appeals addressed the application of the Energy Exemption where a manufacturer or processer (a "toller") for a fee (a "toll charge") manufactures or processes materials owned by another person at the toller's plant facility (a "tolling facility") for a charge. The Board held that the toller should not include the cost of materials produced at another facility as a raw material or direct material cost in the computation of the cost of production at the tolling facility, thereby lowering the toller's costs of production and increasing the exempt portion of the toller's energy purchases.

More recently, the Kentucky Court of Appeals held that a parent company which operated as a toller of materials owned by its wholly owned subsidiary was not entitled

to exclude the subsidiary's cost of materials when calculating the parent's sales and use tax Energy Exemption and the similar UGRLT energy exemption. The parent company created the subsidiary and then transferred to the subsidiary all of its inventory of raw materials and finished goods. The subsidiary had no employees and commingled its assets with the parent company. Applying substance over form principles, the Court held that the parent and subsidiary were "one entity for purposes of taxation." *Ohio Valley Alum. Co., LLC v. Dep't. of Revenue*, Ky. Ct. App. Case No. 2013-CA-00507 (Sept. 12, 2014)(unpublished) rev. den., Ky. Sup. Ct. Case No. 2014-SC-00619 (Aug. 12, 2015).

H.B. 487 amends the sales and use tax Energy Exemption (but not the UGRLT exemption) to provide that cost of production shall be computed on the basis of a plant facility, which shall "include all operations within the continuous, unbroken, integrated manufacturing or industrial processing process that ends with a product packaged and ready for sale." (H.B. 487, sec. 44, amending KRS 139.480(3)). H.B. 487 also appears to require tollers to include the cost of materials they manufacture or process by providing as follows:

> If a person who independently performs a manufacturing or industrial processing production activity for a fee, applies for the exemption under this subsection, and does not take ownership of the tangible personal property that is incorporated into, or becomes the product of the manufacturing or industrial processing activity, then all costs of production, including raw material costs, shall be allocated in proportion to all manufacturing or industrial processing operations at the plant facility.

(Id.) H.B. 487 does not provide a mechanism for a toller to obtain the cost of materials from its customers.

8. Definitional Changes to Prewritten Computer Software

Kentucky currently imposes the sales and use taxes on sales and purchases of prewritten computer software. H.B. 487 makes clarifying changes to the definition of prewritten computer software. These changes do not appear substantive.

9. Repeal of the Exemption for Pollution Control Facilities

Kentucky currently exempts from the sales and use taxes sales and purchases of property that has been certified as a "pollution control facility." In addition to the sales and use tax exemption, property which is certified as a pollution control is subject to a reduced, state only property tax rate and is excluded from the numerator and denominator of the property apportionment factor for income tax purposes.

H.B. 366 repeals the sales and use tax exemption. It is unclear what effect this repeal will have. (H.B. 366, sec. 44, amending KRS 139.480). It appears that pollution control facilities can continue to be "certified", a requirement for the property tax and income tax benefits. H.B. 366 does not repeal the statute authorizing the application for certification (KRS 224.1-310). As for sales and use tax, pollution control equipment is often required by law and may still qualify for the exemption for machinery for new and expanded industry. *Dept. of Revenue v. State Contracting & Stone, Inc.*, 572 S.W.2d 421 (Ky. 1978); see also *Revenue Cabinet v. AMAX Coal Co.*, 718 S.W.2d 947 (Ky. 1986).

10. Nexus/Mail Order and Internet Sales

The U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) held that the Commerce Clause of the United State Constitution prohibits a state from requiring an out-of-state vendor to register and collect use tax on sales made into that state unless the vendor has something more than the slightest physical presence within the state (a "substantial nexus"). As a result of that decision, out-of-state retailers making mail order and internet sales into a state cannot be required to collect the destination state's sales and use taxes on those sales. The U.S. Supreme Court recently granted certiorari in a case that challenges the continuing viability of *Quill*. See *South Dakota v. Wayfair, Inc., et al*, U.S. Supreme Court Case No. 17-494. The Court is widely expected to modify or overturn its ruling in *Quill*.

H.B. 366 anticipates that *Quill* will be overturned and requires out-of-state retailers who currently lack a substantial nexus with the state to register and collect Kentucky use taxes on their sales to in-state customers if those sales exceed a certain threshold. (H.B. 366, secs. 36 and 42, amending KRS 139.010 and 139.340). The registration requirement is effective for transactions occurring on or after July 1, 2018. (Id. at sec. 143). The bill requires any "**remote retailer**" selling tangible personal property or digital property delivered or transferred electronically to a purchaser in Kentucky to collect use tax if: (a) the remote retailer sold tangible personal property or digital property that was delivered to a purchaser in Kentucky in 200 or more separate transactions in the previous calendar year or the current calendar year; or (b) 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 this state in the previous calendar year or current calendar year exceeds $100,000.

"**Remote retailer**" is defined as a retailer with no physical presence in Kentucky but does not include a "marketplace facilitator" or a "referrer." A "**marketplace facilitator**" is defined as a person that facilitates the retail sale of tangible personal property or digital property by listing or advertising the tangible personal property for sale at retail and either directly or indirectly through agreements or arrangements with third parties, collects the payment from the purchaser, and transmits the payment to the person selling the property (e.g., ebay.com, Amazon.com, Etsy, etc.). A "**marketplace retailer**" is defined to mean a person that has an agreement with a

marketplace facilitator and makes retail sales of tangible personal property or digital property through a "marketplace" (e.g., ebay.com and Amazon FBA (fulfillment by Amazon) sellers). A "**marketplace**" is defined to mean any physical or electronic means through which one or more retailers may advertise and sell or lease tangible personal property or digital property, such as a catalog, Internet Web site, or television or radio broadcast, regardless of whether the tangible personal property, digital property, or retailer is physically present in Kentucky. A "**referrer**" is defined to mean a person that: (a) contracts with a retailer or retailer's representative to advertise or list tangible personal property or digital property for sale or lease; (b) makes referrals by connecting a person to the retailer or the retailer's representative, but not acting as a marketplace facilitator; and (c) received in the prior calendar year or the current calendar year, in the aggregate at least $10,000 in consideration from remote retailers, marketplace retailers, or representatives of remote retailers or marketplace retailers for referrals on retail sales to purchasers in Kentucky.

Minnesota, Pennsylvania, Rhode Island, Washington and others have enacted similar legislation.

11. Suspension of the Motion Picture Refundable Sales and Use Tax Credit

Kentucky currently provides a sales and use tax incentive for motion picture companies to produce films in the state. See KRS 139.538 to 139.5386. A motion picture company which chooses a location in Kentucky for the filming or production of a motion picture is exempt from sales and use tax on purchases of tangible personal property made in connection with the filming or production of a motion picture. The exemption is accomplished by granting a refundable credit for sales and use taxes paid on those purchases. The company pays sales and use tax at the time of its purchases and then applies to the Department of Revenue for a refund of the tax. The company must notify the Department prior to filming the picture of its Kentucky address and must apply for the tax refund within sixty (60) days of the completion of filming or production in Kentucky.

H.B. 366 suspends the operation of the credit. (H.B. 366, sec. 46, amending KRS 139.548). The Department may not accept any new applications for the tax credit from the effective date of H.B. 366 until July 1, 2022.

B. Income Taxes

The federal Tax Cuts and Jobs Act (P.L. 115-97) was signed into law on December 22, 2017 and virtually all of its provisions take effect January 1, 2018. H.B. 366 changes Kentucky's Internal Revenue Code ("IRC") reference date for Kentucky incomes taxes to the IRC in effect on December 31, 2017, exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect no December 31, 2017, that would otherwise terminate. (H.B. 366, sec. 53, amending KRS 141.010). The change in the IRC reference date

and the changes to the corporate and individual income taxes discussed below are effective for taxable years beginning on or after January 1, 2018. (Id. at sec. 144). H.B. 366 reduces the generally applicable corporate and individual income tax rates, makes certain changes to the corporate and individual income tax bases, and adopts single sales factor apportionment for multistate companies. H.B. 487 adopts mandatory unitary combined reporting for corporate members of unitary business groups for taxable years beginning on or after January 1, 2019. Members of unitary business group may make an eight-year binding election to file consolidated corporate income tax returns with all members of their federal affiliated group.

1. Individual Income Tax

Rate changes. Kentucky currently imposes the individual income tax at rates brackets ranging from two percent (2%) to six percent (6%). For taxable years beginning on or after January 1, 2018, H.B. 366 imposes the tax at a flat 5% tax rate. (H.B. 366, sec. 57, amending KRS 141.020).

Base changes. Individuals are taxable on their Kentucky net income. H.B. 366 makes the following changes to the calculation of Kentucky net income:

Code reference: As noted above, the Code reference date is Dec. 31, 2017. (Id. at sec. 53, amending KRS 141.010).

Adjusted gross income: H.B. 366 makes the following changes to the calculation of Kentucky adjusted gross income for individuals. The bill reduces the exclusion for distributions from “pension plans, annuity contracts, profit-sharing plans, retirement plans, or employee savings plans” from $41,110 to $31,110. The bill repeals the exclusions previously allowed for amounts (a) paid for health insurance for the taxpayer, taxpayer’s spouse and dependents during the taxable year; and (b) paid during taxable year for insurance for long-term care as defined in KRS 304.14-600. H.B. 366 requires individuals to add back depreciation amounts allowed under IRC §§ 167 and 168 but excludes amounts allowed for depreciation by KRS 141.0101 when calculating adjusted gross net income – IRC §§ 168 and 179 deductions as in effect Dec. 31, 2001). (H.B. 366, sec. 55). H.B. 487 makes one additional change, requiring individuals when calculating their adjusted gross income to add back the amount deducted under IRC § 199A (the new deduction for up to 20% of an individual’s domestic qualified business income from pass-through entities and sole proprietorships created by the federal Tax Cuts and Jobs Act). (H.B. 487, sec. 55 (creating new KRS 141.010(1)(n)).

Net income: H.B. 366 makes the following changes to the calculation of net Kentucky net income for individuals. The bill repeals the deductions from Kentucky adjusted gross income previously allowed for (a) the value of the leasehold interest of property contributed to a charitable organization if the leased property is to be used by the charitable organization to provide temporary living quarters for a homeless family

(Id. at sec. 140 (repealing KRS 141.0202)); (b) amounts paid for vouchers or similar instruments that provide health insurance coverage to employees or their families; and (c) the Kentucky domestic production activities deduction. (Id. at sec. 55).

H.B. 366 denies any of the following federal deductions previously allowed: (a) investment interest allowed by IRC § 163; (b) taxes allowed by IRC §164; (c) losses allowed by IRC § 165; (d) medical care expenses allowed by IRC § 213; (d) moving expenses allowed by IRC § 217; and (e) other miscellaneous deductions allowed by IRC § 67. (Id. at sec. 55).

Personal tax credit reduced. Kentucky currently allows a personal tax credit of $10 for each individual and each dependent. H.B. 366 eliminates the credit for taxable years beginning on or after Jan. 1, 2018. (H.B. 366, sec. 57, amending KRS 141.020). H.B. 366 does not impact the existing personal tax credits in the cases of a fiduciary ($2), an estate ($10) and a taxpayer who is a member of the Kentucky National Guard at the close of the taxable year ($20).

Part-year residents. Effective for taxable years beginning on or after Jan. 1, 2018, H.B. 487 adds a definition for "part-year resident" as "any individual that has established or abandoned Kentucky residency during the calendar year" and makes conforming changes (H.B. 487, secs. 53 and 57 (amending KRS 141.010 and 141.020)). The individual income taxation of part-year residents is unchanged.

Credit for taxes paid to other jurisdictions clarified. Current law authorizes individuals a credit against their Kentucky individual income tax on income from sources without Kentucky equal to the income tax paid to "the other state." Current law similarly exempts nonresident individuals from Kentucky individual income tax if the laws of the individual's "state" of residence providers for a reciprocal exemption. KRS 141.070(1) and (2). There is no specific definition of "state" for purposes of this provision. However, KRS 446.010, Kentucky's general definitional statute, recognizes that "state" can include "any foreign government or country." See KRS 446.010(40). The Department nevertheless regularly rejects attempts to credit foreign income taxes against the Kentucky individual income tax.

Effective for taxable years beginning on or after Jan. 1, 2018, H.B. 487 amends KRS 141.070 to define "state" as used in that section to mean "a state of the United

States, the District of Columbia, the commonwealth of Puerto Rico, or any territory or possession of the United States." (H.B. 487, secs. 118 and 153; compare KRS 141.120(1)(h) (defining "state" for purposes of the apportionment statute to include "any foreign country or political subdivision thereof.").

2. Corporate Income Tax

Rate changes: Kentucky currently imposes the corporate income tax at rates brackets ranging from four percent (4%) to six percent (6%). For taxable years beginning on or after January 1, 2018, H.B. 366 imposes the tax at a flat 5% tax rate. (H.B. 366 at sec. 48, amending KRS 141.040).

Base changes: Corporations are taxable on their Kentucky taxable net income. H.B. 366 makes the following changes to the calculation of Kentucky taxable net income:

Code reference: As noted above, the Code reference date is Dec. 31, 2017. (H.B. 366 at sec. 53, amending KRS 141.010).

Gross Income: H.B. 366 makes the following changes to the calculation of Kentucky gross income for corporations. The bill repeals the exclusions from Kentucky gross income previously allowed for (a) income from "safe harbor leases" (IRC § 168(f)(8)); (b) amounts received by tobacco producers and quota owners under the Master Tobacco Settlement Agreement; (c) and amounts received under the secondary settlement fund for tobacco farmers and quota owners; and (d) amounts received from funds of the Commodity Credit Corporation for the Tobacco Loss Assistance Program; (e) amounts received as a result of the tobacco quota buydown program; and (f) Phase II payments received by a producer of tobacco or a tobacco quota owner. H.B. 366 requires corporations to add back depreciation amounts allowed under IRC §§ 167 and 168 in calculating gross income (but continues the existing deduction for depreciation allowed by KRS 141.0101 when calculating net income – IRC §§ 168 and 179 deductions as in effect Dec. 31, 2001). (Id. at sec. 56, creating a new statute).

Net Income: H.B. 366 makes the following changes to the calculation of Kentucky net income for corporations. The bill repeals the deductions from Kentucky gross income previously allowed for (a) the value of the leasehold interest of property contributed to a charitable organization if the leased property is to be used by the charitable organization to provide temporary living quarters for a homeless family (H.B. 366, sec. 140, repealing KRS 141.0202); (b) amounts paid for vouchers or similar instruments that provide health insurance coverage to employees or their families; (c) Kentucky domestic production activities deduction; (d) expenses related to "safe harbor leases" (IRC § 168(f)(8)). The bill expressly allows the deduction for depreciation allowed by KRS 141.0101 when calculation Kentucky net income. (H.B. 366, sec. 56).

Allocation and apportionment generally: H.B. 366 substantially re-writes Kentucky's corporate income allocation and apportionment provisions for multi-state taxpayers. The bill clarifies that taxpayers having income from business activity which is taxable both within and without Kentucky must allocate and apportion their net income. (H.B. 366, sec. 60, amending KRS 141.120(2)). Former "nonbusiness income" is now designated as "non-apportionable income." The bill clarifies that a taxpayer is taxable in

another state if (a) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not do so. (Id., amending KRS 141.120(3)).

Under the allocation provisions of existing law, net rents and royalties from intangible personal property located in Kentucky are allocable to the state. For that purpose royalties from property leased in Kentucky shall be considered as royalties from intangible personal property. H.B. 366 removes these provisions.

Current law also provides that for purposes of allocation of income, a copyright is utilized in a state to the extent that printing or other publication originates in the state. Further, if the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the corporation's commercial domicile is located. H.B. 366 removes these provisions.

Adoption of single-sales factor apportionment. Current law provides that taxpayers apportion income using a three factor formula (property, payroll and sales) with the sales factor being double-weighted. H.B. 366 adopts single sales factor apportionment (the "receipts factor"). (H.B. 366, sec. 60, amending KRS 141.120)). The bill maintains the flow-through of the receipts factor to corporate owners of pass-through entities, but moves that authority from KRS 141.120(11) to KRS 141.121(6)(as amended). See also KRS 141.206(9)(a) and (11)(as amended).

The bill excludes from the receipts factor receipts from hedging transactions and the maturity, redemption, sale, exchange, loan, or other disposition of cash or securities. KRS 141.120(1)(e)(as amended). The assignment of receipts from the sale of tangible personal property is the same as current law. However, the location of a purchaser's "designee" where property is delivered or shipped is no longer considered for purposes of assigning sales.

H.B. 366 adopts market sourcing for purposes of assigning receipts from sales other than sales of tangible personal property. Such receipts are assigned to Kentucky if the taxpayer's market for the sales is in the state. KRS 141.120(11)(a)(as amended). A taxpayer's market for sales is in Kentucky as follows: (a) in the case of sale, rental, lease, or license of real property, if an to the extent the property is located in Kentucky; (b) in the case of rental, lease, or license of tangible personal property, if an to the extent the property is located in Kentucky; and (c) in the case of sale of a service, if an to the extent the service is delivered to a location in Kentucky. Id. A taxpayer's market for sales is in Kentucky in the case of intangible property (a) that is rented, leased, or licensed, if an to the extent the property is used in Kentucky, provided that intangible property utilized in marketing a good or service to a consumer is used in Kentucky if that good or service is

purchased by a consumer who is in Kentucky; and (b) that is sold, if an to the extent the property is used in Kentucky, provided that (i) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is used in Kentucky if the geographic area includes all or part of Kentucky; (ii) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease, or licensing of the intangible property under (a) above; and (iii) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the receipts factor. Id. If the state or states of assignment of receipts from sales other than sales of tangible personal property cannot be determined, the state or states of assignment "shall be reasonably approximated." Finally, H.B. 366 adopts a throwout rule for such receipts which are assigned to a state in which the taxpayer is not taxable or where a state of assignment cannot be determined or reasonably approximated.

Alternative Apportionment. H.B. 366 adds a provision that specifies the showing a taxpayer or the Department must make when petitioning for or requiring an alternative apportionment method. The petitioning taxpayer or the Department, as the case may be, must show by clear and convincing evidence (a) the regular allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in Kentucky; and (b) that the alternative to the provisions is reasonable. However, the Department does not bear the burden of proof if it can show that in any two of the prior five taxable years, the taxpayer had used an allocation or apportionment method at variance with its allocation or apportion method used for the other taxable years. KRS 141.120(12)(c)(as amended). The Department cannot revoke written permission to use an alternative apportionment method for prior transactions and activities unless there has been a material change in, or a material misrepresentation of, the facts provided by the taxpayer on which the Department reasonably relied. Id. at 12(e).

H.B. 366 retains the provisions of existing law that allow corporations to elect special apportionment provisions for business income relating to the sale of services to or on behalf of regulated investment companies and from the sale of securities brokerage services but moves them from KRS 141.120(9)(b) to KRS 141.121(4)(as amended).

H.B. 366 retains the provisions of existing law that require public service companies and financial organizations to apportion their income pursuant to methods specified by administrative regulations. See KRS 141.120(10) and 103 KAR 16:100 to 16:150. H.B. 366 excludes public service companies and financial organizations from the standard apportionment regime, moves the authority for regulatory methods from KRS 141.120(10) to KRS 141.121(5), and mandates single receipts factor apportionment for these companies and organizations. Note also that H.B. 366 amends the definition of "financial organization" excluded from the standard apportionment regime and subject

to a regulatory method. An excluded financial organization now includes a "small loan company", a "sales finance company" and "any similar type of entity" but no longer includes a "credit union" or "any type of insurance company."

H.B. 487 excludes from the standard apportionment regime any person receiving gross revenues from multichannel video programming service or communication service in Kentucky (i.e., cable and telecommunications companies). (H.B. 487, sec. 60). Corporations engaged in the business of providing communications service (as defined in KRS 136.602), cable service (as defined in KRS 136.602) or internet access (as defined in 47 U.S.C. sec. 151), shall continue to calculate their apportionment fraction using the three factor formula under current law (KRS 141.120). (H.B. 487, sec. 78, amending KRS 141.121).

Apportionment and allocation for passenger airlines. Current law authorizes passenger airlines and qualified air freight forwarders to apportion their business income using special property, payroll and sales factors. KRS 141.121. H.B. 366 amends these provisions for taxable years beginning on or after January 1, 2018 to provide for a single revenues factor for passenger airlines and air freight forwarders. The new revenue factors are calculated identical to the sales factor under current law.

3. Corporate Income Tax – Reporting (Consolidated/Unitary Combined)

Consolidated returns – H.B. 366 (taxable years beginning on or after January 1, 2018 and, if H.B. 487 becomes law, prior to January 1, 2019). Current law requires a consolidated corporate income tax return be filed by affiliated groups of "includible corporations." A corporation must have a nexus with Kentucky to be an includible corporation. Current law excludes from the definition of "includible corporation" (a) any corporation that realizes a net operating loss whose Kentucky property, payroll and sales factors are *de minimis* and (b) any corporation for which the sum of the property, payroll and sales factors is zero. KRS 141.200(9)(b)7. and 8. Consistent with its adoption of a single sales apportionment factor, H.B. 366 amends these exclusions to exclude loss corporations whose receipts factor is *de minimis* and corporations for which the receipts factor is zero. (H.B. 366, sec. 79, amending KRS 141.200).

Combined/elective consolidated returns – H.B. 487 (taxable years beginning on or after January 1, 2019). Unless vetoed, H.B. 487 limits Kentucky's current mandatory nexus consolidated return provisions in KRS 141.200 to taxable years beginning prior to January 1, 2019. H.B. 487 creates two new statutes that for tax years beginning on or after January 1, 2019, require "corporations" that are members of "unitary business groups" to file combined income tax returns (co-called "combined reports") or elect to file a consolidated return with all members of their federal affiliated group. (H.B. 487, secs. 119, 120, and 154). All other corporations are required to file separate returns or elect to file a consolidated return with all members of their federal affiliated group. (Id.)

Corporations to file separate, combined or elective consolidated returns. For taxable years beginning on or after January 1, 2019, H.B. 487 requires every corporation doing business in Kentucky that is not a member of a "unitary business group" and not otherwise exempted from the corporation income tax to file a separate income tax return. (H.B. 487, sec. 119(3) and (4)). Every corporation that is doing business in Kentucky that is a member of a "unitary business group" and not otherwise exempted is required to file a "combined report." In lieu of filing separate or combined reports, a corporation may make an election to file a consolidated return with all members of the federal affiliated group. A federal affiliated group may elect to file a consolidated return regardless of whether or not the group files a federal consolidated return. The election is to be made on a form to be prescribed by the Department and must be submitted on or before the due date of the return (including extensions) for the first taxable year for which the election is made. The election is binding for eight years. (Id.) "Unitary business group" is not defined.

"Unitary business" is defined to mean a single economic enterprise that is made up either of separate parts of a single corporation or a commonly controlled group of corporations that sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. For purposes of the requirement to file a combined report, the term "unitary business" shall be broadly construed, to the extent permitted by the United States Constitution. (H.B. 487, sec. 120(2)(f)).

"Corporation" means "corporation" as defined in IRC § 7701(a)(3) (KRS 141.010(24)(a)) and includes an organization of any kind treated as a corporation for Kentucky corporate income tax purposes, wherever located, which if it were doing business in this state would be a taxpayer. The business conducted by a pass-through entity which is directly or indirectly held by a corporation shall be considered the business of the corporation to the extent of the corporation's distributive share of the pass-through entity income, inclusive of guaranteed payments. (Id., sec. 119(2)(b)).

"Combined group" is defined to mean the group of all corporations whose income and apportionment factors are required to be taken into account in determining the taxpayer's share of the net income or loss apportionable to Kentucky. (Id., sec. 120(2)).

Combined report. A combined report must include the income and the apportionment fraction (single sales factor) of all corporations that are members of the unitary business. (Id., sec. 120(3)). Members of a combined reporting group may "as a filing convenience" annually designate one taxpayer member of the combined group to file a single return in lieu of filing their own respective returns. (Id., sec. 120(9)).

Consolidated and separate returns generally. The existing definitions of "consolidated return" and "separate return" contained in KRS 141.200 are incorporated into the new filing method statute. (Id., sec. 119(2)). The existing provisions that require the exclusion from nexus consolidated returns of loss corporations with *de minimis* apportionment factors or corporations with zero factors do not apply to consolidated returns filed for taxable years beginning on or after January 1, 2019). (See id., sec. 79, amending KRS 141.200). The existing provisions that disallow deductions on separate returns for intangible expense, intangible interest expense and management fees for affiliated entities or related parties (KRS 141.205) are unchanged and continue to apply for separate returns filed for taxable years beginning on or after January 1, 2019.

Consolidated returns. As noted above, H.B. 487 limits Kentucky's mandatory nexus consolidated return provisions in KRS 141.200 to taxable years that begin prior to January 1, 2019. H.B. 487 does not include any detailed provisions regarding how a consolidated return is to be filed under its new elective consolidated return regime. Instead, H.B. 487 simply defines "consolidated return" to mean a Kentucky corporation income tax return filed by members of an "affiliated group" (as defined in IRC § 1504(a) and related regulations). The determinations and computations required for Kentucky income tax purposes shall be made in accordance with IRC § 1502 and related regulations, "except as required by differences between [KRS Chapter 141] and the Internal Revenue Code. Corporations exempted from the Kentucky corporate income tax shall not be included in the return. (Id., sec. 119(2)(b)). An affiliated group electing to file a consolidated return shall be treated for all Kentucky corporate income tax purposes as a single corporation. All transactions between corporations included in the consolidated return shall be eliminated in computing net income and determining the apportionment fraction. (Id., sec. 119(4)).

Kentucky taxable income of a taxpayer member of a combined group. Each taxpayer member of a combined business group is responsible for tax based on its taxable income or loss apportioned or allocated to Kentucky (id., sec. 120(4)), which shall be determined as follows for each of the combined groups of which the taxpayer is a member:

(1) Determine total income of the combined group. To determine the total income of the combined group, taxpayer members shall take into account all or a portion of the income and apportionment factor of only the following members otherwise included in the combined group (Id., sec. 120(8)):

- Any member incorporated in the U.S. or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States (include entire income and apportionment percentage);
- Any member that earns more than 20% of its income, directly or indirectly, from intangible property or service related activities that are deductible against the apportionable income of other members of the combined group (include to the extent of that income and the

apportionment factor related to that income)(e.g., intangible holding companies);

- Any member that is doing business in a tax haven (include the entire income and apportionment factor). "Tax haven" is defined to mean a jurisdiction that, during the taxable year has no or nominal effective tax on the relevant income and satisfies one of five other requirements (See Id., sec. 120(2)(d));
- If a unitary business includes income from a pass-through entity, include the member of the combined group's direct and indirect distributive share of the pass-through entity's unitary income;
- Defer income from intercompany transactions between members of the combined group similar to the method used under the federal consolidated return regulations (subject to later recognition upon the occurrence of listed events);
- Deduct any charitable expense incurred by a member of a combined group to the extent allowed by IRC § 170, applying the income limitations to the entire apportionable income of the group. The remainder of the deduction is treated as a nonapportionable expense allocable to the member that incurred the expense to the extent allowed by IRC § 170, applying the income limitations to the nonapportionable income of that specific member. Any remaining deduction disallowed but allowed as a carryover is treated as originally incurred in the subsequent year by the same member, subject to the same limitations in that subsequent year;
- Any expense of one member of the unitary group which is directly or indirectly attributable to the nonapportionable or exempt income of another member of the unitary group shall be allocated to that other member as corresponding nonapportionable or exempt expense, as appropriate; and,
- Gain or loss from the sale or exchange of capital assets (as described in IRC § 1231(a)(3)), and property subject to an involuntary conversion shall be removed from the total separate net income of each member of a combined group ("Special Gain or Loss") and shall be apportioned and allocated as follows:

  For each class of Special Gain or Loss (short-term capital, long-term capital, IRC § 1231, and involuntary conversions), all members' gain and loss for each class shall be combined, without netting between the classes, and each class of net gain or loss separately apportioned to each member using the member's apportionment percentage;

  Each taxpayer member shall then net its apportioned business Special Gain or Loss for all classes, against the taxpayer member's nonapportionable gain and loss for all classes allocated to Kentucky (using the rules of IRC §§ 1231 and 1222) without regard to any of the taxpayer member's gains or losses from each of the classes; and,

Any resulting state source loss of a member that is subject to the limitations of IRC § 1211 (limiting deduction of corporation capital losses to the extent of corporation capital gains) shall be carried forward by that member, and treated as state source short-term capital loss incurred for the year for which the carryover applies.

(2) Determine apportionable income of the combined group. The apportionable income of a combined group is determined by taking the total income of the combined group (as determined in the immediately preceding step) and subtracting nonapportionable income, expenses or losses of the group. The total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes (no intercompany eliminations). To determine apportionable income of the combined group, subtract from that total income any income and add any expense or loss, other than the apportionable income, expense, or loss of the combined group. (H.B. 487, sec. 120(7)); and,

(3) Determine the taxpayer's share of the apportionable income of the combined group apportioned to Kentucky. The taxpayer's share of the business income apportionable to Kentucky of each combined group of which it is a member is the product of: (a) the apportionable income of the combined group (as determined in the immediately preceding step); and (b) the taxpayer member's single-sales factor apportionment fraction. The taxpayer member's apportionment fraction is determined by including in the sales factor numerator the taxpayer's sales associated with the combined group's unitary business in Kentucky, and including in the denominator the sales of all members of the combined group (including the taxpayer). Sales of a pass-through entity shall be included in the determination of the partner's apportionment percentage in proportion to a ratio, the numerator of which is the amount of the partner's distributive share of the pass-through entity's unitary income and the denominator of which is the amount of the pass-through entity's total unitary income. (Id., sec. 120(6)).

Kentucky corporate income tax of a taxpayer member of a combined group. Each taxpayer member of the unitary business groups is responsible for Kentucky corporate income tax based on its taxable income or loss apportioned or allocated to Kentucky (id., sec. 120(5)), which shall include:

(a) The taxpayer's share of the apportionable income apportioned to Kentucky of each of the combined groups of which it is a member;

(b) The taxpayer's share of any income apportioned to Kentucky of a distinct business activity conducted within and without the state wholly by the taxpayer member, determined under the standard single-sales factor apportionment formula;

(c) The taxpayer's income from a business conducted wholly by the taxpayer member entirely within Kentucky;

(d) The taxpayer's income sourced to Kentucky from the sale or exchange of capital or assets, and from involuntary conversions (the Special Gain or Loss above);

(e) The taxpayer's nonapportionable income or loss allocable to Kentucky determined under Kentucky's standard income allocation provisions;

(f) The taxpayer's income or loss allocated or apportioned in an earlier year, required to be taken into account s state source income during the income year, other than a net operating loss ("NOL"); and,

(g) The taxpayer's NOL carryover. If the taxable income results in a loss for a taxpayer member of the combined group, that taxpayer member has a Kentucky NOL, subject to the NOL limitations and carryforward provisions of KRS 141.011. The NOL is applied as a deduction in a subsequent year only if that taxpayer has Kentucky source positive net income, whether or not the taxpayer is or was a member of a combined reporting group in the subsequent year.

Credit and deduction limitations. No tax credit or post-apportionment deduction earned by one member of the group, but not fully used by or allowed to that member, maybe used in whole or in part by another member of the group or applied in whole or in part against the total income of the combined group. A post-apportionment deduction carried over into a subsequent year as to that member that incurred it, and available as a deduction to that member in a subsequent year, will be considered in the computation of the income of that member in the subsequent year, regardless of the composition of that income as apportioned, allocated, or wholly within this state.

Discretionary powers. The Department is given broad authority to include additional corporations and/or their income and apportionment factors in the combined report:

Inclusion to reflect proper apportionment. The Department may promulgate administrative regulations requiring that the combined report include the income and associated apportionment factors of any corporations that are not included but that are members of a unitary business, "in order to reflect proper apportionment of income of the entire unitary businesses." This authority to require combination includes the authority to require combination of corporations "that are not, or would not be combined, if the corporation were doing business in this state." (H.B. 487, sec. 120(3)(b)).

Inclusion to prevent avoidance or evasion of tax. If the Department determines that the reported income or loss of a taxpayer engaged in a unitary business with any corporation not included represents an avoidance or evasion of tax by the taxpayer, the Department may, on a case-by-case basis, require all or any part of the income and associated apportionment factors of the corporation be included in the taxpayer's combined report. (H.B. 487, sec. 120(3)(c)).

C. Ad Valorem Taxes

1. New Income Tax Credit for Local Ad Valorem Taxes on Inventory

Current law allows the state and various local governments to impose ad valorem taxes on inventories – machinery inventory, equipment inventory, motor vehicles inventory, raw materials (including distilled spirits and distilled spirits inventory), in-process materials, finished goods and personal property placed in a warehouse or distribution center for the purpose of subsequent shipment outside the state. H.B. 366 provides for a nonrefundable and nontransferable credit against the individual income tax or the corporation income tax and limited liability entity tax for any taxpayer that on or after January 1, 2018 pays an ad valorem tax to the state or any political subdivision on inventories. (H.B. 366, sec. 115). The new credit is effective for taxable years beginning on or after July 1, 2018 and is similar to the distilled spirits credit provided by KRS 141.389. (Id. at 144).

The credit phases in as follows:

Inventory Tax Paid For Taxable Year	Credit %
Beginning on or after Jan. 1, 2018 and before Jan. 1, 2019	25%
Beginning on or after Jan. 1, 2019 and before Jan. 1, 2020	50%
Beginning on or after Jan. 1, 2020 and before Jan. 1, 2021	75%
Beginning on or after Jan. 1, 2021	100%

If the taxpayer is a pass-through entity, the taxpayer may applied the credit against the limited liability entity tax and pass the remaining credit through to its members, partners, or shareholders in the same proportion as the distributive share of income or loss is passed through. (Id. at sec. 115).

2. Prewritten Computer Software Exempt from Ad Valorem Taxes

H.B. 487 exempts computer software, except prewritten computer software, is exempt from state and local ad valorem taxes for assessment dates beginning on or

after January 1, 2019. "Prewritten computer software" is as defined in KRS 139.010 for sales and use tax purposes. (H.B. 487, sec. 36).

D. Tobacco Taxes

Kentucky currently imposes a cigarette excise tax of sixty cents ($0.60) per pack of twenty (20) cigarettes. H.B. 366 increases the tax rate to one dollar and ten cents ($1.10) per pack of twenty (20) cigarettes on sales of cigarettes on or after July 1, 2018. (H.B. 366, secs. 27 and 141). The increase in the rate is also implemented through a floor stocks tax on inventory as of June 30, 2018 to ensure that all cigarettes sold on or after July 1, 2018 have been subject to the new tax paid. (Id. at sec. 27). The tax rates on tobacco products other than cigarettes are unchanged.

E. Local Occupational License Fees/Taxes

Current law provides a complicated set of rules governing whether a taxpayer may credit an occupational license fee or tax ("OLF") imposed by a city against an OLF imposed by the county in which the city is located. In counties having a population of thirty thousand (30,000) or more, taxpayers paying a city OLF may credit that amount against their county OLF upon agreement between the city and county. KRS 68.197(6). However, if the county OLF was imposed on or after July 15, 1986 and was not impose pursuant to a public question approved by the voters, the credit is mandatory notwithstanding any agreement between the city and county. Id. at (7) and (10)(a); *King v. Campbell County*, 217 S.W.3d 862 (Ky. App. 2006). This mandatory credit did not apply during the period March 14, 2012 through July 15, 2014 unless both the city and county had levied and were collecting license fees on March 15, 2012. KRS 68.197(8). If the county levied its OLF prior to July 15, 1986 and the levy was not pursuant to a public question approved by the voters, taxpayers may credit a city OLF against the portion of the county tax rate increased on or after July 15, 1986. *City of Covington v. Kenton County*, 149 S.W.3d 358 (Ky. 2004).

H.B. 366 provides that where, at the time the bill takes effect, a county has levied an OLF on or after July 15, 1986 and a city within that county has levied an OLF but not as yet collected it, a taxpayer may credit the city OLF against the county OLF as follows:

Period	Credit %
From July 1, 2016 through June 30, 2017	Applies to first 0.1% of the tax rate imposed by the County
From July 1, 2017 through June 30, 2018	Applies to first 0.2% of the tax rate imposed by the County

H.B. 487 supersedes and changes these provisions to apply for the 2019 and 2020 fiscal years. H.B. 366 provides that any city and county subject to this restriction may enter into an

interlocal agreement to establish a revenue-sharing arrangement that differs from these requirements. (H.B. 366, § 136).

H.B. 366 further provides that notwithstanding any other statutes, (a) any existing set-off or credit of city license fees against county license fees and any existing OLF revenue sharing agreement between a city and county continue to apply until June 30, 2018; (b) the mandatory credit of city OLF against a county OLF imposed on or after July 15, 1986 and not pursuant to a public question approved by the voters (KRS 68.197) does not apply unless both the city and the county have levied and are collecting license fees on the date H.B. 366 takes effect; and (c) a city or county subject to these provisions may enter into a OLF revenue sharing arrangement that differs from these requirements. (H.B. 366, § 137).

Finally, H.B. 366 provides any county that has enacted a OLF at a rate greater than one percent (1%) prior to reaching a population of thirty thousand (30,000) and has a revenue sharing agreement with its largest city may increase its OLF if the county and its largest city enter into an agreement approving the rate increase and provide for sharing of the increased tax revenues. Other cities within the county may join the agreement if agreed to by all parties. (H.B. 366, § 138). Similar provisions were included in the 2015-2016 Transportation Cabinet Budget. See H.B. 236 (2014), Part VI, Secs. 2-4, 2014 Ky. Acts 127.

These provisions appear tailored to address a long running dispute between Knox County and the City of Corbin over the ability of city OLF taxpayers to credit those payments against the county's OLF. Knox County levied its OLF in 1999. Corbin levied its OLF in 2005. At least for a period of years, Corbin did not attempt to collect its OLF. The Court of Appeals previously held that KRS 68.197(8) prevented taxpayers from crediting amounts paid to Corbin against the Knox County OLF. *City of Corbin v. Knox County*, Ky. Ct. App. Case Nos. 2013-CA-000984 and 2013-CA-001090 (May 23, 2014)(Unpublished), rev. den., (Ky. 2015); see also *City of Barbourville v. Knox County Fiscal Court*, 80 S.W.3d 765 (Ky. App. 2001), rev. den (Ky. 2002).

H.B. 366's OLF provisions are not codified, apply solely during the 2015-2016 biennium, and expire June 30, 2020. (H.B. 366, sec. 145). H.B. 487 changes these provisions to make them apply solely during the 2019-2020 biennium and expire June 30, 2020. (H.B. 487, secs. 145 and 155).

F. Other Changes – Waste Tire Fee

Kentucky imposes a $1.00 "waste tire fee" on the purchase of all new replacement motor vehicle tires of $1.00 which fee is collected by the retailer from the consumer. The fee is to expire June 30, 2018. The fee funds the Energy and Environment Cabinet's efforts to rid Kentucky's landscape of waste tires. The fee is excluded from the calculation of the sales tax on the sale of the tire.

H.B. 366 extends the tire fee to June 30, 2020 and increases the fee to $2.00 for each new motor vehicle tire sold on or after July 1, 2018. The increased fee is subject to Kentucky sales tax. (H.B. 366, sec. 2, amending KRS 224.50-868).

G. Suspension or Amendment of Tax Incentives

Film Industry Incentives – Income Tax Credit. Kentucky authorizes a film incentive for qualifying applicants making minimum investments for feature-length films, television programs, industrial films, documentaries, and commercials. The incentive allows qualifying applicants to recover up to 20% of qualified expenditures made for production work in Kentucky through a refundable income tax credit. The applicant must apply at least 30 days before an expenditure occurs. Applications are approved by the Kentucky Film Office, Tourism, Arts and Heritage Cabinet, Finance and Administration Cabinet and the Kentucky Tourism Development Finance Authority. See KRS 148.542 to 148.548.

Effective for taxable years beginning on or after January 1, 2018, H.B. 366 amends the program to exclude commercials from productions that can qualify for the tax incentive. The bill changes the income tax credit incentives from a refundable to a nonrefundable credit for applications approved on or after the bill's effective date. The bill also caps that total tax incentive that can be approved under the program to $100 million for calendar year 2018 and each calendar year thereafter. (H.B. 366, secs. 61 and 62).

Possible Suspension of Kentucky Industrial Revitalization Act (KIRA) Incentives. KIRA authorizes incentives for companies requiring investments in (a) existing manufacturing or agribusiness operations facilities that are in imminent danger of permanently closing or that have closed temporarily, where twenty-five (25) jobs are created or maintained; or (b) the rehabilitation of coal mining and processing facilities that have closed, been temporarily suspended, or severely reduced that intend to employ a minimum of five hundred (500) persons and have a raw production of at least three hundred million (300,000,000) tons. Qualifying companies may receive state income tax credits and job development assessment fees for up to seventy-five percent (75%) of the costs of the rehabilitation or construction of buildings and the refurbishing or purchasing of machinery and equipment. See KRS Ch. 154.26.

H.B. 366 suspends the KIRA program, prohibiting the Kentucky Economic Development Finance Authority from accepting any new applications or preliminarily approving applications until on or after July 1, 2022. (H.B. 366, sec. 95). H.B. 487 supersedes H.B. 366 and repeals H.B. 366's suspension of the KIRA program. (H.B. 487, sec. 95).

Possible Suspension of Kentucky Investment Fund Act (KIFA) Incentives. KIFA authorizes a forty percent (40%) credit against and the Kentucky individual and corporate income taxes relating to investments in approved investment funds. See KRS Ch. 154.20-250 to 154.20-284.

H.B. 366 suspends the KIFA program, prohibiting the Kentucky Economic Development Finance Authority from accepting any new applications or preliminarily approving applications

until on or after July 1, 2022. (H.B. 366, sec. 97). H.B. 487 supersedes H.B. 366 and repeals H.B. 366's suspension of the KIFA program. (H.B. 487, sec. 99).

Suspension of Kentucky Angel Investment Act (KAIA) Incentives. KAIA authorizes angel investors (persons providing capital for startup companies) to receive a credit against the Kentucky individual and corporate income taxes relating to investments in approved small businesses. Qualified investors can receive a tax credit of up to fifty percent (50%) of their investment in counties with high unemployment rates and up to forty percent (40%) in all other counties. See KRS 154.20-230 to 154.20-240.

H.B. 366 suspends the KAIA program, prohibiting the Kentucky Economic Development Finance Authority from accepting any new applications until on or after July 1, 2022. (H.B. 366, sec. 99). H.B. 487 supersedes H.B. 366 and provides that the Kentucky Economic Development Finance authority shall not approve applications under KAIA received on or after January 1, 2019 but may resume approving applications received on or after Jan. 1, 2021. (H.B. 487, sec. 98). H.B. 487 imposes new caps on the amounts of credits that can be awarded after the suspension ends. H.B. 487 imposes an annual cap on KIFA incentives, limiting the total amount of credit that may be awarded each year to $3,000,000 for all qualified investors and no more than $200,000 to any one individual qualified investment. (Id.) H.B. 487 further imposes an overall limit of $40,000,000 on the total amount of credit that may awarded under KIFA for all years prior to Dec. 31, 2020. (Id.)

Reporting to the General Assembly. H.B. 366 enacts a number of provisions that provides for the Department of Revenue and the Cabinet for Economic Development to report on prior incentive awards to the Interim Joint Committee on Appropriations and Revenue to allow the Committee to evaluate the efficacy of each program. The programs to be evaluated are the Film Industry Credit, KIRA, KIFA, and KAIA.

H. KY-CPA Proposals

The Kentucky Society of CPAs made a number of tax reform proposals which were adopted by H.B. 366.

Prohibition of third-party auditors or legal counsel hired on a contingency basis. H.B. 366 prohibits the Department of Revenue from hiring outside auditors or lawyers on a contingency basis. The bill prohibits entering into any arrangement or contract for the service of examining a taxpayer's books and records, of collecting a tax from a taxpayer, or for legal representation of the Department, if any part of the compensation or other benefits paid or payable for the service is contingent upon or otherwise related to the amount of tax, interest, fee, or penalty assessed against or collected from the taxpayer. Any such arrangement or contract shall be void and unenforceable. (H.B. 366, sec. 100, amending KRS 131.081). This change is effective when the bill becomes effective.

No posting of a supersedeas bond required. H.B. 366 amends the statutes governing the Kentucky Claims Commission to provide that if a taxpayer appeals an assessment and loses the appeal at the Commission, the collection of the tax shall be stayed by the filing of a petition or an appeal to any court. Full payment of the tax or the posting of a supersedeas bond is not required to appeal an order sustaining a tax assessment. (H.B. 366, sec. 101, amending KRS 49.520). This change has no special effective date and becomes effective when H.B. 366 takes effect under its emergency clause.

This change was intended to address the Department of Revenue's recent, unusual request that a taxpayer post a bond or alternative security during the pendency of that taxpayer's appeal from a decision of the Kentucky Board of Tax Appeals to the Franklin Circuit. The Franklin Circuit Court denied the Department's request, holding that taxpayers are not required to post bond during the appeal process to the circuit court because "the posting of supersedeas bond is only applicable for appeals taken from this Court and not to this Court." *Chegg, Inc. v. Dept. of Revenue*, Franklin Cir. Ct. (Div. II) Action No. 14-CI-00170 (March 26, 2014). The Court of Appeals subsequently denied the Department's petition for a writ of mandamus to compel the Franklin Circuit court to require the posting of a bond. *Dept. of Revenue v. Hon. Thomas D. Wingate*, Ky. Ct. App. No. 2014-CA-000855 (Aug. 14, 2014). H.B. 366 removes any question that no supersedeas bond is required.

Protest period extended to sixty (60) days. Current law requires a taxpayer to protest a notice of tax assessed by the Department within forty-five (45) days from the date of the notice. H.B. 366 extends the protest period to sixty (60) days from the date of the notice for assessments issued on or after July 1, 2018. (H.B. 366, sec. 106). This change has no special effective date and becomes effective when H.B. 366 takes effect under its emergency clause.

Submission of RARs extended to ninety (90) days. Current law requires a taxpayer to submit to the Department of Revenue a copy of the final determination of a federal audit of the taxpayer's federal income tax return within thirty (30) days of the conclusion of the federal audit. H.B. 366 extends the time to file the final determination with the Department to ninety (90) days. (H.B. 366, sec. 114, amending KRS 141.210). H.B. 487 supersedes H.B. 366 and extends the time to file the final determination with the Department to one-hundred eighty (180) days. H.B. 487, sec. 114, amending KRS 141.210). This change has no special effective date and becomes effective when H.B. 366 takes effect under its emergency clause.

I. Repeal of Tax Credits and Incentives

Repeal of the nonrefundable coal incentive income tax credit. Current law allows a nonrefundable coal incentive tax credit against the corporate income tax, individual income tax and public service company property tax for Kentucky coal purchased and used for the purpose of generating electricity. An electric power company or a company that owns and operates a coal-fired electric generating plant may be entitled to the credit. Only coal that is subject to Kentucky's coal severance tax qualifies for the credit. The credit amount is equal to two dollars ($2.00) per ton of Kentucky coal purchased by the company that is above the amount of

Kentucky coal purchased during the base year. The credit has expired for all facilities other than alternative fuel facilities and gasification facilities. See KRS 141.0405 and 141.0406.

H.B. 366 repeals the coal incentive credit effective as of the date the bill takes effect under its emergency clause. (H.B. 366, sec. 140, repealing KRS 141.0405 and 141.0406).

Repeal of the nonrefundable income tax credit for new home purchases. Kentucky law allowed a one time, nonrefundable new home tax credit against the individual income tax. A credit of five thousand dollars ($5,000) was available to a resident who purchased a single-family dwelling as his or her principal residence between July 26, 2009 and Dec. 31, 2010. See KRS 141.388.

H.B. 366 repeals the tax credit for new home purchases effective as of the date the bill takes effect under its emergency clause. (H.B. 366, sec. 140, repealing KRS 141.388).

Repeal of the income tax credit for donated edible agricultural products. Since 2013, Kentucky law allows persons who grow or raise edible agricultural products an income tax credit for donating such products to nonprofit food programs operating in Kentucky. The credit is equal to ten percent (10%) of the value of the donated products and can be taken against the Kentucky individual tax or corporate income tax and limited liability entity tax. See KRS 141.392.

H.B. 366 repeals the tax credit for new home purchases effective as of the date the bill takes effect under its emergency clause. (H.B. 366, sec. 140, repealing KRS 141.392).

Repeal of the Kentucky Jobs Retention Act (KJRA). Enacted in 2007, the KJRA allows economic development incentives for qualifying companies engaged in automobile, automobile parts or supplies, household appliance, or household appliance parts or supplies manufacturing and employing at least one thousand (1,000) full-time persons, operating in Kentucky for at least five (5) years, to obtain economic development incentives for a jobs retention project costing not less than one hundred million dollars ($100,000,000) for the purposes of reinvesting in its operations and retaining a significant number of existing jobs in Kentucky. The incentives available are equal to up to fifty percent (50%) of the eligible costs of project. The incentives can be taken over a ten (10) year period in the form of a one hundred percent (100%) credit against the income and limited liability entity taxes on the income, gross receipts and gross profits from the project and an up to five percent (5%) wage assessment from the gross wages of employees whose jobs was preserved or created as a result of the project. See KRS Ch. 154.25.

H.B. 366 repeals the KJRA effective as of the date the bill takes effect under its emergency clause. (H.B. 366, sec. 140, repealing KRS Ch. 154.25).

Repeal of the Kentucky Incentives for Energy Independence Act (KIEIA). Enacted in 2007 and substantially revised in 2011, the KIEIA allows economic development incentives for qualifying companies that construct, retrofit or upgrade a facility to: (a) generate electricity

for sale through alternative methods such as solar or wind power, biomass resources, landfill methane gas, hydropower, or other renewable resources; (b) increase the production and sale of (i) alternative transportation fuels; (ii) synthetic natural gas, chemicals, chemical feed stocks, or liquid fuels, from coal, biomass resources, or waste coal through a gasification process; or (iii) energy-efficient alternative fuels. The minimum capital investment requirements range from one to one hundred million dollars ($1,000,000 - $100,000,000), depending on the type of facility. The incentives available are equal to up to fifty percent (50%) of the eligible costs of project. The incentives can be taken over a twenty-five (25) year period in the form of an up to one hundred percent (100%) credit against the income and limited liability entity taxes on the income, gross receipts and gross profits from the project, up to eighty percent (80%) of the Kentucky severance tax paid on coal or natural gas, refunds of sales and use tax paid on purchases of tangible personal property for the facility, and an up to four percent (5%) wage assessment from the gross wages of employees whose jobs were created as a result of the project. See KRS Ch. 154.27.

H.B. 366 repeals the KIEIA effective as of the date the bill takes effect under its emergency clause. (H.B. 366, sec. 140, repealing KRS Ch. 154.27). With the repeal of the KIEIA, Kentucky has no economic development program exclusively devoted to renewable energy projects. H.B. 557, adopted April 14, expands the Kentucky Business Investment Act (KRS Ch. 154.12) to renewable energy production projects (wind power, biomass resources, landfill methane gas, hydropower, solar power, or other similar renewable resources to generate electricity for sale). The Governor has ten days (excluding Sundays) to veto H.B. 557. Because the General Assembly has adjourned, any gubernatorial veto cannot be overridden by the legislature.

Repeal of the Kentucky Environmental Stewardship Act (KESA). Enacted in 2005, the KESA allows economic development incentives for qualifying companies that undertake an environmental stewardship project to acquire, construct and install equipment and facilities to manufacture an environmental stewardship product which is a unique product that has a substantial positive impact on the environment. The project must cost at least five million dollars ($5,000,000) and project employees are subject to certain minimum wage levels. The incentives available are up to twenty-five percent (25%) of the project’s fixed asset costs and up to one hundred percent (100%) of employee skills training costs. The incentives can be taken over a ten (10) year period in the form of a one hundred percent (100%) credit against the income and limited liability entity taxes on the income, gross receipts and gross profits from the project. See KRS 154.48.

H.B. 366 repeals the KESA effective as of the date the bill takes effect under its emergency clause. (H.B. 366, sec. 140, repealing KRS 154.48).