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Kentucky General Assembly Passes \$105 Million Tax Decrease (Detailed analysis of Ky. H.B. 354 (2019))

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On March 13, 2019 the 2019 Kentucky General Assembly adopted H.B. 354, legislation originally billed as necessary to make corrections to the substantial tax changes enacted last year. H.B. 354 in its final form does much more, making sweeping changes to Kentucky's taxation of banks and other depository institutions. The bill now goes to Governor Matt Bevin and will become law if not vetoed within the ten-day veto period.

In 2018, Kentucky enacted two acts that made 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.¹ The 2018 acts were estimated to raise nearly \$395 million over the state's 2019-2020 biennium. When fully implemented, H.B. 354's corrections to those 2018 acts along with H.B. 354's further changes are estimated to reduce state collections by \$105 million annually.

A review of the significant tax changes made by H.B. 354 (the "**Act**") follows.

A. Sales and Use Tax

Unless otherwise specifically noted, the Act's sales and use tax changes are effective for transactions occurring on or after July 1, 2019. (Act § 82).

1. *De Minimis* (\$6,000) Exemption from Taxable Services

The 2018 General Assembly expanded the Kentucky sales tax to eleven new classes of services effective July 1, 2018. See KRS 139.200(2)(g) – (q).² The Act exempts from sales and

¹ H.B. 366 (2018) and H.B. 487 (2018). The text of H.B. 366 can be viewed at the following address: <https://apps.legislature.ky.gov/law/acts/18RS/documents/0171.pdf>. The text of H.B. 487 can be viewed at the following address: <https://apps.legislature.ky.gov/law/acts/18RS/documents/0207.pdf>.

² The sales tax was expanded to the following services: (1) landscaping services; (2) janitorial services; (3) small animal veterinary services; (4) pet care services; (5) industrial laundry services; (6) non-coin operated laundry and

use tax the gross receipts from these newly taxable services if the vendor's total gross receipts do not exceed \$6,000 during the calendar year. When gross receipts from these services exceed \$6,000 in a calendar year, gross receipts in excess of that threshold amount are taxable and the vendor becomes fully taxable in subsequent calendar years. This change applies to the 2018 calendar year and subsequent calendar years. (Act § 26, amending KRS 139.470.) The *de minimis* exemption does not apply if the vendor is also engaged in selling tangible personal property, digital property, admissions, or prepaid calling arrangements, or furnishing lodging, sewer services, telecommunications services or natural gas distribution, transmission or transportation services (those items and services taxable under KRS 139.200(a) – (f)).

2. Certain Admissions Excluded from Tax

The 2018 General Assembly expanded Kentucky's existing sales tax on admissions to include fees paid for the privilege of using facilities or participating in an event or activity. The Act amends the admissions tax to exclude the following:

- (a) Any fee paid to enter or participate in a fishing tournament;
- (b) Any fee paid for the use of a boat ramp for the purpose of allowing boats to be launched into or hauled out of the water; or
- (c) Admissions to "unarmed combat shows" (boxing, kickboxing, sparring, wrestling, missed martial arts, or muay thai) regulated by the Kentucky Boxing and Wrestling Commission which are taxed under KRS 229.031.

(Act §§ 19 and 20, amending KRS 139.010 and KRS 139.200, respectively.)

The Act also excludes admissions charged by 501(c)(3) organizations and other nonprofit organizations, discussed in subparagraph (8) below. (Act §§ 19, 28 and 29, amending KRS 139.200, KRS 139.495 and creating a new statute, respectively).

3. Certain Extended Warranty Services Excluded from Tax

The 2018 General Assembly expanded Kentucky's sales and use taxes to extended warranty services. See KRS 139.200(2)(q). The Act excludes the following from taxation of extended warranty services:

dry cleaning services; (7) linen supply services; (8) indoor skin tanning services; (9) non-medical diet and weight reducing services; (10) limousine services; and (11) extended warranty services.

[T]he sale of a service agreement for tangible personal property to be used by a small telephone utility as defined in KRS 278.516 or a Tier III CMRS provider as defined in KRS 65.7621 to deliver communications services as defined in KRS 136.602 or broadband as defined in KRS 278.5461.

(Act § 19, amending KRS 139.010).

4. Small Animal Veterinary Services for Poultry Excluded from Tax

The 2018 General Assembly expanded the Kentucky sales tax to small animal veterinary services. See KRS 139.200(2)(i). The Act excludes from taxation veterinary services for poultry. (Act § 20, amending KRS 139.200).

5. Use Tax Expanded to Services

As noted above, the 2018 General Assembly expanded the Kentucky **sales** tax to eleven new classes of services. See KRS 139.200(2)(g) – (q). Those changes did not apply to the **use** tax, which applies only to the purchase of tangible personal property and digital property.

The Act makes a number of definitional changes in an attempt to expand the **use** tax to services effective for transactions occurring on or after July 1, 2019. (Act §§ 17-25, 28-30, 33, 34 and 83.)

6. Resale Exemption Authorized for Services

The Act allows a resale exemption for services purchased for resale. (Act §§ 21, 22, and 23, amending KRS 139.260, 139.270, and 139.280, respectively.)

7. Clarification of Taxable Marketplace Providers

The 2018 General Assembly amended the nexus provisions of the sales and use tax to require out-of-state retailers with no physical presence in Kentucky (so-called “remote retailers”) to register and collect Kentucky use taxes on sales to in-state customers if those sales exceed certain thresholds. See KRS 139.340. The change was made in anticipation of the U.S. Supreme Court’s decision in South Dakota v. Wayfair, Inc., et al, __ U.S. __, 138 S.Ct. 2080 (June 1, 2018). The Department of Revenue began enforcing these new requirements beginning October 1, 2018. The 2018 changes expressly excluded “marketplace facilitators” and “referrers” from the definition of “remote retailers.”

The Act makes further clarifications to last year’s Wayfair-related changes, removing all references to “referrer” and expanding the concept of marketplace facilitators (now called “marketplace providers”) to those facilitating sales of taxable services. (Act § 19.) The Act requires that marketplace providers, whose direct sales and/or sales facilitated by the marketplace providers to in-state customers exceed certain thresholds, must register, file

returns and collect and remit the tax due on those direct and facilitated sales. (Id. and §§ 19, 24, 25 and 33, amending KRS 139.010, 139.340, 139.450, and 139.550, respectively).

8. Charitable / Nonprofit “Fix”

Charitable institutions generally are exempt from sales and use tax on their **purchases**. KRS 139.495. However, it has been clear since the Kentucky Supreme Court’s ruling in Children’s Psychiatric Hospital, Inc. v. Revenue Cabinet, 989 S.W.2d 583 (Ky. 1999), that charitable institutions are subject to sales tax on their **sales**. Kentucky provides nonprofit organizations a limited \$1,000 annual exemption for fundraising events and exempts sales by certain school and school-sponsored organizations. See KRS 139.496 and 139.497. The Department of Revenue nevertheless chose not to enforce the sales tax against charities. In mid-2018, the Department began making public statements that it would begin enforcing the tax.

The Act exempts charitable organizations and other nonprofit organizations from sales tax on the following sales:

- (a) Sales of admissions; or
- (b) **Fundraising event sales.**

(Act §§ 28 and 29, amending KRS 139.495 and creating a new statute, respectively). “**Fundraising event sales**” are not defined, but they do not include sales related to the operation of a retail business, such as thrift stores, bookstores, surplus property auctions, recycle and reuse stores, or any ongoing operations in competition with for-profit retailers. All other sales by charitable organizations and other nonprofit organizations remain taxable.

For purposes of these new exemptions, charitable organizations are “resident, nonprofit educational, charitable, or religious institutions which have qualified for exemption from income taxation under Section 501(c)(3) of the Internal Revenue Code.” See KRS 139.495, as amended. Other nonprofit organizations are “nonprofit civic, governmental, or other nonprofit organizations.” (Act § 29.)

9. Energy Exemptions / Tollers

The Act amends the existing sales and use tax and utility gross receipts license tax exemptions for energy purchased for use in manufacturing or industrial processing.

There is a limited sales and use tax exemption for energy purchased for use in manufacturing of industrial processing. The exemption applies to the portion of the energy purchased during the year that exceeds three percent (3%) of the annual cost of production at the plant facility (the “energy exemption”). See KRS 139.480(3). A similar energy exemption applies to the utility gross receipts license tax for schools. See KRS 160.613(3). Manufacturers

and processors that do not own the materials they manufacture or process are known as “tollers” and generally do not include the costs of those materials when calculating their plant facility’s cost of production for purposes of the energy exemption. See Logan Aluminum, Inc. v. Revenue Cabinet, Ky. Bd. Tax App. Order No. K-14952 (1993); Northland Corp. v. Revenue Cabinet, Ky. Bd. Tax App. Order No. K-11389 (1987), *aff’d*, Franklin Cir. Ct. Case No. 87-CI-0298 (1988), *aff’d*, Ky. Ct. App. Case No. 88-27-S (Ky. App. 1988)(unpublished). See also Northland Custom Processing, LLC v. Finance and Administration, Dep’t of Revenue, Ky. Bd. Tax App. Order No. K-25070 (2016).

The 2018 General Assembly amended the energy exemption to require all tollers to include their customers’ raw materials costs when calculating their cost of production. This change occurred as the result of a court decision in which a company had restructured as a “toller” in a transaction that lacked economic substance. Ohio Valley Alum. Co., LLC v. Dep’t. of Revenue, Ky. Ct. App. Case No. 2013-CA-00507 (Ky. App. 2014)(unpublished), *rev. den.*, Ky. Sup. Ct. Case No. 2014-SC-00619 (Ky. 2015)(denying status as a toller because the manufacturer and its customer really were “one entity for purposes of taxation.”).

The Act clarifies that tollers that lack economic substance must include their customers’ raw materials costs when calculating the energy exemption. The Act specifies the requirements for economic substance and makes conforming changes to both the sales tax and utility gross receipts license tax for schools. (Act §§ 27, 74 and 75, amending KRS 139.480, 160.613, and 160.6131, respectively.) The new economic substance requirements are effective for facilities that begin tolling operations after July 1, 2018.

B. Income Taxes

Unless otherwise specifically noted, the Act’s income tax changes are effective for taxable years beginning on or after January 1, 2019. (Act § 83.)

1. Update to Internal Revenue Code Reference Date

The Act updates the Internal Revenue Code (“**IRC**” or “**Code**”) reference date to the Code in effect on December 31, 2018 for purposes of the Kentucky income taxes for taxable years beginning on or after January 1, 2019. (Act § 35, amending KRS 141.010.)

2. Deduction for Bonus Depreciation

The Act updates the reference to the IRC § 179 bonus depreciation deduction. For property placed in service prior to January 1, 2020, Kentucky allows the Section 179 deduction in effect on December 31, 2001. For property placed in service on or after January 1, 2020, Kentucky allows the Section 179 deduction in effect on December 31, 2003. (Act § 36, amending KRS 141.0101.)

3. Deduction for Investment Interest

The Act allows the IRC § 163 deduction for investment interest for individual income tax purposes. (Act § 37, amending KRS 141.019.)

4. Deduction for Wagering Losses

The Act allows the IRC § 165(d) deduction for wagering losses for individual income tax purposes. (Act § 37, amending KRS 141.019.)

5. Estimated Taxes

The Act conforms estimated tax payments of Kentucky individual income tax, corporation income tax and limited liability entity tax (LLET) to the federal treatment and methodology. Estimated tax payments are required if either individual income tax or both corporation income tax and LLET are “reasonably expected” to exceed \$5,000 and shall be made at the same time and calculated in the same manner as estimated tax payments for federal income tax purposes. (Act §§ 42, 52, 58, 59 and 80, amending KRS 141.044, 141.305, 141.985, and 141.990 and repealing KRS 141.042 and 141.300, respectively.)

6. Corporate Extensions

The Act increases the extended due date for corporation income tax returns from the current six months to seven months. (Act § 45.)

7. Corporate Income Tax Filing Method

The 2018 General Assembly amended Kentucky’s corporation income tax to require for taxable years beginning on or after January 1, 2019 that members of unitary business groups file a mandatory unitary combined return. Members of a unitary business group may make an eight-year binding election to file a consolidated corporation income tax return with all members of their federal affiliated group in lieu of a combined return. See KRS 141.201.

For consolidated filers, the Act reduces the binding election period from eight years to four years. (Act § 47, amending KRS 141.201.) The Act makes the following changes to the combined reporting method:

- Clarifies that a combined group includes only corporations the voting stock of which is more than 50% owned, directly or indirectly, by a common owner or owners (Act § 48, amending KRS 141.202);
- Clarifies that “tax haven” does not include a jurisdiction that has entered into a comprehensive U.S. income tax treaty (Id.);

- Clarifies that the combined return shall be filed on a waters-edge basis (Id.);
- Clarifies that a unitary business when preparing its combined return shall consider the combined gross receipts and combined income from all sources of all members after eliminating intercompany transactions (Id.); and
- Clarifies that a combined return does not include the income and apportionment percentages of group members that earn 80% or more of their income from foreign sources (Id.).

8. Recycling Credit³

The Act amends the recycling credit for major recycling projects by (i) reducing the jobs requirement down from 750 to 400 full-time employees, (ii) reducing the total credit from 50% to 25% of the total installed costs of the recycling equipment, (iii) expanding the credit recovery period from 10 to 30 years, and (iv) allowing the credit to be claimed annually in an amount up to 75% of the total tax liability due for the taxable year. (Act § 53.)

The Act also expands the filing date of the application for the recycling credit to the later of the seventh month following the close of the taxable year in which the recycling equipment is purchased or placed in service (Act § 53.) The recycling credit changes are effective for taxable years beginning on or after January 1, 2021. (Id. at § 84.)

C. Ad Valorem Taxes on Tangible Personal Property

Unless otherwise specifically noted, the Act's ad valorem tax changes are effective for tangible personal property assessed on or after January 1, 2020. (Act § 84.)

1. New State Tax Rate Class For "Qualified Heavy Equipment"

The Act creates "qualified heavy equipment" as a new class of tangible personal property subject to a reduced **state** ad valorem tax of five cents (\$0.05) upon each one hundred dollars (\$100) of value. (Act §§ 8 and 9, amending KRS 132.010 and 132.020, respectively.) The **local** ad valorem taxation of qualified heavy equipment is unchanged.

"**Qualified heavy equipment**" is defined to mean machinery and equipment, including ancillary equipment and any attachments used in conjunction with the machinery and equipment that is:

- (1) Primarily used and designed for construction, mining, forestry, or industrial purposes, including but not limited to cranes, earthmoving equipment, well-

³ The Act also made changes to the family-size credit. (Act § 43, amending KRS 141.066.)

drilling machinery and equipment, lifts, material handling equipment, pumps, generators, and pollution-reducing equipment; and

- (2) Held in a **heavy equipment rental company's** inventory for: (a) Rental under a **heavy equipment rental agreement**; or (b) Sale in the regular course of business.

KRS 132.010(30).

“Heavy equipment rental company” is defined to mean an entity that is primarily engaged in a line of business described in Code 532412 or 532310 of the North American Industry Classification System Manual in effect on January 1, 2019.

“Heavy equipment rental agreement” is defined to mean the short-term rental contract under which qualified heavy equipment is rented without an operator for a period: (1) not to exceed three hundred sixty-five (365) days; or (2) that is open-ended under the terms of the contract with no specified end date.

2. *De Minimis* Exclusion from Tax

The Act excludes taxpayers from the requirement to file a tangible personal property tax return and list property for any address where the taxpayer's total taxable tangible personal property at that address has a fair cash value of \$1,000 or less. (Act § 10, amending KRS 132.220.)

3. Protest Period Extended to 60 Days

In 2018, the General Assembly extended the general deadline to protest notices of tax assessed by the Department from forty-five (45) days to sixty (60) days for notices issued on or after July 1, 2018. The Act makes a conforming change to Kentucky's ad valorem tax statutes, clarifying that Department notices of increases in the assessed value of tangible personal property also may be protested within sixty (60) days. (Act § 11, amending KRS 132.360.) This change does not have a special effective date and takes effect ninety days after adjournment of the legislative session. See Ky. Const. § 55.

D. Miscellaneous Excise Taxes

1. Phased Repeal of the State Bank Franchise Tax

Kentucky imposed the “bank franchise tax” in 1996 to replace the state ad valorem tax on financial institution deposits struck down in St. Ledger v. Commonwealth, 912 S.W.2d 34 (Ky. 1995). The bank franchise tax consists of a state franchise tax and authorized local franchise taxes on banks and trusts companies. The state franchise tax is an annual tax imposed at 1.1% of the financial institution's apportioned net capital. Cities and counties are authorized to impose annual local franchise taxes of up to 0.025% (for cities and counties) or up to 0.050%

(for urban-counties) of deposits held in branches located within their jurisdiction. See KRS 136.500 – 136.575.

The Act phases in a repeal of the bank franchise tax. (Act §§ 14 – 16, 40, and 41). For the 2021 calendar year, financial institutions are subject to both the bank franchise tax and the Kentucky corporation income and LLET taxes. (Act § 14, creating a new statute in KRS Chapter 136.) Financial institutions are allowed a refundable credit of their state bank franchise tax against their Kentucky income tax. (id.) For taxable years beginning on or after January 1, 2022, the bank franchise tax “shall no longer apply to financial institutions.” (id.)

2. Extension of the State Multichannel Video Programming Services Tax and Utility Gross Receipts License Tax for Schools to Netflix and other Video Streaming Services

The Act amends the definition of “multichannel video programming service” to clarify that taxable services include live, scheduled, or on-demand programming that is comparable to or in competition with programming provided by a television broadcast station and expressly includes “video streaming services.” (Act § 17, amending KRS 136.602.) This change is effective for transactions occurring on or after January 1, 2019 (id. §82.)

This amendment addresses the decision of the former Kentucky Board of Tax Appeals in Netflix, Inc. v. Finance and Administration Cabinet, Department of Revenue, Ky. Bd. Tax App. Order No. K-24900 (Sept. 23, 2015), which held that Netflix’s streaming services were not taxable “multichannel video programming services” because they were neither “cable service” nor comparable to television broadcast station programming.

The definitional change applies for purposes of state gross revenues tax on multichannel video programming services (KRS 136.616), the state excise tax multichannel video programming services (KRS 136.604) and the local utility gross receipts license tax for schools (KRS 160.613 – 160.617).

3. Wholesale Excise Tax on Wine / Small Wineries

Kentucky imposes a wholesale excise tax on wholesalers of wine equal to 10% of their gross receipts from wholesale sales. See KRS 243.884. Gross receipts derived from sales of wine produced by a small farm winery are excluded from the tax if the small farm winery produces no more than 50,000 gallons of wine per year. Id. at (3).

The Act clarifies that the small farm winery exclusion applies to the **first** 50,000 gallons of wine produced by a small farm winery in a calendar year, ensuring that sales of more than 50,000 gallons of wine from a small farm winery in a given year does not cause the first 50,000 gallons to become taxable. (Act § 77, amending KRS 243.884.)

E. Open Records Act/Taxpayer Confidentiality

The Act amends Kentucky's Open Records Act and taxpayer confidentiality statutes to address pending litigation and clarify the disclosure obligations of state and local officials involved with tax administration. The Act clarifies that taxpayer confidential information is excepted from the disclosure requirements of the Kentucky Open Records Act. (Act §§ 1 and 5, amending KRS 61.878 and 131.190, respectively). The Act further clarifies that the following are considered taxpayer confidential information protected from disclosure:

- (1) Unappealed final rulings issued by the Department of Revenue;
- (2) Requests for guidance from the Department;⁴
- (3) Private letter rulings; or
- (4) Requests for alternative income tax apportionment methods and any response thereto.

(Act § 5, amending KRS 131.190). The Act also clarifies that taxpayer documents, data and other information which is considered taxpayer confidential information cannot be obtained in litigation discovery and cannot be required to be produced by the Kentucky Claims Commission or local property tax assessment appeals boards. (*Id.*, providing that such information "shall not be subject to ... the Kentucky Rules of Civil Procedure, or any other order issued by an administrative hearing officer or administrative board or commission"). To the extent this change prohibits discovery in the Kentucky courts, it appears to conflict with the Kentucky Supreme Court's exclusive authority to prescribe rules of practice and procedure. *See* Ky. Const. § 116. Finally, the Act confirms that production of taxpayer confidential information may be produced pursuant to a court order. (Act §§ 5 and 7, amending KRS 131.190 and 131.990, respectively)

These changes address pending litigation. In Finance and Administration Cabinet, Department of Revenue v. Sommer, Ky. Sup. Ct. Case No. 2017-SC-000071 (Nov. 1, 2018), an evenly divided Kentucky Supreme Court failed to decide the Department of Revenue's appeal of a lower court decision requiring the Department to produce redacted final rulings, including rulings which taxpayers did not appeal. Justice VanMeter, who was a dissenting member of the Court of Appeals' panel that heard the case, recused himself after his election to the Kentucky Supreme Court. The Department of Revenue moved the state's highest court to reconsider its split decision and that motion has not been decided.

⁴ The Department issued Kentucky Revenue Procedure KY-RP-17-01 (Dec. 1, 2017) providing that upon request, the Department will provide guidance to taxpayers concerning its interpretation of Kentucky's tax laws and regulations in the form of technical advice memorandums, revenue procedures, private letter rulings, and general information letters.

In Finance and Administration Cabinet, Department of Revenue v. Shepherd, et al., Ky. Ct. App. Case No. 2018-CA-001659 (Jan. 14, 2019), the Kentucky Court of Appeals denied the Department's request for a writ prohibiting enforcement of Franklin Circuit Court Judge Phillip J. Shepherd's order compelling the Department to produce a letter containing confidential taxpayer information. The Department has moved for discretionary review of the Court of Appeals' decision. See Finance and Administration Cabinet, Department of Revenue v. Shepherd, et al., Ky. Sup. Ct. Case No. 2019-SC-000104.

F. Economic Development

The Act sunsets an existing Kentucky economic development incentive program and reverses the suspension of various other economic development incentive programs that occurred in 2018. The reversals of last year's changes are generally retroactive to April 14, 2018. (Act § 85.)

1. Sunset of the KY Tourism Development Act ("TDA")

The Act sunsets the TDA economic development program. See KRS 139.536 and KRS 148.850 – 148.860. Beginning July 1, 2020, further applications for that program will not be accepted. (Act §§ 32 and 60.)

2. Renewal of the KY Angel Investment Act ("AIA")

The 2018 General Assembly suspended the incentives under the AIA, prohibiting the Kentucky Economic Development Finance Authority ("**KEDFA**") from approving applications under AIA received on or after January 1, 2019 but allowing KEDFA to resume approving applications received on or after Jan. 1, 2021. The Act repeals the suspension, once again allowing applications for AIA incentives to be filed and approved. (Act § 61, amending KRS 154.20-232.)

3. Renewal of the KY Investment Fund Act ("IFA")

The 2018 General Assembly suspended the incentives under the IFA, prohibiting the KEDFA from approving applications under IFA received on or after April 14, 2018 but allowing KEDFA to resume approving applications received on or after July 1, 2022. The Act repeals the suspension, once again allowing applications for IFA incentives to be filed and approved. (Act § 62, amending KRS 154.20-250.)

4. Renewal of the KY Industrial Revitalization Act ("KIRA")

The 2018 General Assembly suspended the incentives under KIRA, prohibiting the KEDFA from approving applications under KIRA received on or after April 14, 2018 but allowing KEDFA to resume approving applications received on or after July 1, 2022. The Act repeals the

suspension, once again allowing applications for KIRA incentives to be filed and approved. (Act § 67, amending KRS 154.26-095.)