Big Kentucky Tax Issues Facing Businesses

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KEY CONTACTS

Mark Loyd
Bailey Roese
Stephanie Bruns

There is a lot going on with regard to Kentucky taxes of which businesses should be aware, from actual and potential changes to Kentucky's tax system to changes in tax regulations to tax case developments.

Kentucky Tax Modernization?

The Tax Foundation came out with a study in November 2021 entitled, Aligning Kentucky's Tax Code for Growth. There are many ideas contained in the study. Fundamentally, the study advocates the reduction of the individual and corporate income taxes, particularly given the existence of significant local net profit taxes; it seems the goal is to reduce Kentucky state income tax rates to at or near 0%. The study also advocates shifting away from local income taxes which are uncommon in other states as well as aligning local net profits apportionment with the state's to use a single sales factor. For the Commonwealth to be competitive with neighboring states, the combined state and local income tax rates need to be addressed. The study also advocates repealing the Limited Liability Entity Tax, the inventory tax, and the inheritance tax as well as creating a *de minimis* exemption for tangible personal property taxes, reforming the gas tax so that it remains a viable revenue stream for transportation expenditures going forward, and reforming unemployment insurance. Notably, the study advocates a phased approach with revenue triggers to reduce uncertainty while phasing in income tax rate reductions.

Obviously, Kentucky cannot reduce income tax rates without offsetting revenue from other sources, for example, sales taxes and property taxes, which are generally lower in Kentucky than in neighboring states. In this regard, the study suggests considering raising the state sales tax rate and permitting localities to levy sales taxes. The study also identifies potential sales tax base broadeners like taxing food, residential utilities, motor fuels, and certain services (other than business-to-business services). Another option is increasing the state property tax rate (which is a small component of most property taxes) and allowing localities more flexibility in raising property taxes, especially to shift localities away from net profits taxes.

Something else to think about is the importance of anti-pyramiding provisions like Kentucky's manufacturing exemptions.

State and Local Taxes on Remote Worker Wages (and on Businesses)

Kentucky and many taxing districts (*i.e.*, counties, cities, schools, etc.) impose occupational license taxes (effectively income taxes) on wages earned by employees based on each individual's service performed within the tax district.

Fortunately, for Kentucky state income tax purposes, Kentucky employers with employees who reside in states with which Kentucky has a reciprocal agreement, including border states, Indiana, Ohio, Illinois, Virginia, and West Virginia, as well as Michigan and Wisconsin, provide a Kentucky tax exemption for such employees so that Kentucky employers may withhold the employee's resident state income tax. 103 KAR 17:140. These reciprocity agreements simplify compliance relating to remote workers in the sense that the employer can withhold the same state's tax regardless of whether the employer is working in Kentucky or another state based on their residency, for example, withholding Kentucky income tax on Kentucky residents, and withholding Indiana income tax on Indiana residents.

In contrast, employers withhold local occupational license taxes based on where the employee is performing the service. So, an employer based in City A will withhold City A taxes when its employee is working at the employer's location and if employee lives in City B, employer will have to withhold City B taxes. This raises certain practical and logistical issues. For example, an employer may not be set up to track from where employees are working, the employer's payroll service may not be set up to file and pay City B local wage taxes, etc.

Also, as many know, local occupational license tax compliance on business income has been a compliance nightmare, especially for multijurisdictional filers, for many years. While important steps have been made to make these local taxes uniform (KRS 67.750, *et seq.*) and to provide a central location to access ordinances and forms (available at http://app.sos.ky.gov/occupationaltax/), more is needed, especially as remote work becomes the norm.

SALT Cap Workaround for Kentucky?

Since the $10,000 state and local tax deduction limit, *i.e.*, the SALT Cap, was added by the Tax Cuts and Jobs Act of 2017, states have been proposing and enacting SALT Cap workaround legislation. This type of legislation allows a pass-through entity to elect to pay tax on its income, rather than each owner paying tax on their share of the entity's income, similar to the corporate income tax (i.e., an entity level tax). The IRS endorsed this in Notice 2020-75 paving the way for SALT Cap workaround legislation in roughly 20 states.

Is this a recurring nightmare? Is this a dream about Kentucky's short-lived flirtation with a mandatory entity level tax in 2005 and 2006, which re-defined the term "corporation" to include most pass-through entities? Maybe? Maybe not? SALT Cap workarounds are not without their issues, most notably the creditability of other states' taxes.

Should Kentucky adopt SALT Cap workaround legislation? At least in 2022, Kentucky is not the lead ship in uncharted waters as it was in 2005.... If so, what state should Kentucky emulate? Will Congress eliminate the SALT Cap? Will the United States Supreme Court accept the Petition for Certiorari recently filed by several states arguing that Congress's imposition of a $10,000 cap on the SALT deduction violates Article I, Section 8 and the Tenth and Sixteenth Amendments of the United States Constitution?

Tax Amnesty in 2022?

Like a cicada, could tax amnesty be back? Kentucky 2022 House Bill 176 would provide for a tax amnesty program conducted by the Department of Revenue, beginning on October 1, 2022, and ending on November 29, 2022. Amnesty would be available to all taxpayers owing taxes, penalties, fees, or interest subject to the administrative jurisdiction of the Department, with certain exceptions (generally property taxes and locally collected taxes). Notably, under the bill as proposed, amnesty would also be available for federal taxes, penalties, fees, or interest referred to the Department from the federal government for collection purposes. Stay tuned!

Manufacturing Supplies Sales Tax Exemption

The Kentucky Supreme Court granted discretionary review in *Century Aluminum of Kentucky, GP v. Department of Revenue*, 2020-CA-0301-MR (Ky. App. July 9, 2021), *discretionary review granted*, 2021-SC-0300 (Ky. Feb. 16, 2022) which involves the manufacturing supplies exemption of KRS 139.470(9)(b)2.b. Virtually every manufacturer in Kentucky relies on this particular exemption. The Court of Appeals relied upon an exclusion from the supplies exemption, *i.e.*, **"'Supplies' does not include repair, replacement, or spare parts of any kind..." and "The exemption ... does not include repair, replacement, or spare parts[.]",** *Id*. at 2-3 (emphasis in original, quoting KRS 139.470(9)(b)2.b & (e)), to hold that such items were not tax-exempt. The Court of Appeals, borrowing heavily from the Circuit Court, focused its analysis on whether each item at issue was a repair, replacement, or spare part because it was (or was not) "tangible personal property used to maintain, restore, mend, or repair machinery or equipment". *Id*. at 3-4. Should "maintain" be construed in the context of restore, mend or repair? And, should the exclusion be more narrowly construed? After all, it is an exclusion to an exemption, not an exemption itself.

Real Property Taxes

Anecdotally, there has been of late an increase in real property tax appeals. Generally, such a trend results from taxpayers determining that their real property has been over-assessed by the county Property Tax Administrator and exercising their rights to contest the PVA's assessment value. An example of this trend may be found in *Agree Hazard KY, LLC dba Walmart v. Perry County Property Valuation Administrator*, No. K17-S-163 (KCC May 22, 2019), *on appeal*, No. 19-CI-00285 (Perry Cir. Ct. June 21, 2019).

In that case the KBTA (then, the Kentucky Claims Commission) found that the subject property located in Hazard, Perry County, Kentucky, should be assessed using a value derived from the contract rent and noted that such contract rent was a vital factor and must be considered when assessing the property. Such a finding was a notable departure from the recommendations from the Hearing Officer, who had found the contract rent to be above-market and thus inapplicable. The Hearing Officer's Recommended Order stated: "[T]his position implies that consideration, in all cases, is equivalent to the fair cash value. This is not the case. KRS 382.135 makes clear that "consideration" and "fair cash value" are not interchangeable terms." The case is currently on appeal before the Perry County Circuit Court. Similar cases are proceeding through the KBTA and the courts.

Remember to review real property tax assessment values, which, if overstated, must be disputed with the county PVA in May during the open inspection period.

Kentucky Tax Regulations

There were several developments of note in 2021 with regard to Kentucky tax regulations.

Electronic filing is hear to stay. Regulation 103 KAR 1:160, Mandatory Electronic Filing And Payment Requirements, is a new tax regulation concerning electronic filing and electronic payment of income, sales and excise taxes implemented pursuant to KRS 131.250 and KRS 131.155 which also addresses penalties for noncompliance, and provides for waivers of electronic filing requirements.

Regulation 103 KAR 16:270. Apportionment; Receipts Factor, was amended to address, among other things, the receipts factor in the context of financial institutions, which are subject to the corporate income tax, effective for tax years beginning on or after January 1, 2021.

As related by the Department in Kentucky Sales Tax Facts (May 2018), labor and installation charges are included in the definition of "gross receipts" subject to Kentucky sales tax and sales of extended warranty services covering tangible personal property that is taxable at retail to the warranty holder are subject to sales and use tax, as a result of 2018 HB 487, effective July 1, 2018. Regulation 103 KAR 27:150, Repairers and Reconditioners of Tangible Personal Property, and Regulation 103 KAR 27:230, Motor Vehicle Body Shops, interprets the application of sales and use tax to repairers and body shops concerning, among other things, charges for installing or applying taxable repair parts and extended warranty services.

For manufacturers, it should be highlighted that Regulation 103 KAR 30:120, Machinery for New and Expanded Industry, was amended to address, among other things, exempt charges for labor or services to apply, install, repair, or maintain tangible personal property directly used in manufacturing or industrial processing. And, Regulation 103 KAR 30:140, Energy and Energy-Producing Fuels, implements amendments to KRS 139.480(3) in 2019 HB 354 which authorizes a manufacturer or industrial processor with tolling operations at a plant facility that meet certain criteria to exclude the cost of tangible personal property from the toller's cost of production in computing its sales tax exemption for energy costs exceeding 3% of its cost of production.

Regulation 103 KAR 26:131, Landscaping Services, is a new regulation that addresses the application of sales and use tax to landscaping services. These became subject to Kentucky sales and use tax, effective July 1, 2018 pursuant to 2018 HB 487.

Regulation 103 KAR 26:100, Industrial Laundry and Linen Supply Services, amends a longstanding regulation concerning the Department's interpretation of the application of sales and use tax to transactions involving industrial laundry and linen supply services; these services became subject to sales tax as a result of amendments effective July 1, 2018 to KRS 139.200(2) in HB 487. This Regulation merits a close read.

KRS 139.481, enacted effective January 1, 2021, requires farmers to apply for an Agriculture Exemption Number for use on exemption certificates that farmers must present to retailers when making sales tax exempt purchases. However, the amendments to Regulation 103 KAR 30:091, Sales to Farmers, do not appear to address KRS 139.481.

Curiously, for those who remember the Departments tax policies and revenue circulars, Regulation 103 KAR 16:352, Corporation Income Taxes Policies and Circulars, was amended to identify additional Revenue Policies and Revenue Circulars that have been rescinded.

Software as a Service (SaaS)

Businesses are providing and purchasing all types of cloud-based computing services for use in multiple states, including Kentucky. As a result, questions often come up regarding software as a service (SaaS). In Private Letter Ruling KY-PLR-21-01 ("PLR"), the Department recently determined that an application provided as part of a Software as a Service model, also known as SaaS, was not subject to Kentucky sales tax. The taxpayer in the PLR provides web-based service via a SaaS model;

this involves its customers accessing prewritten computer software hosted online with no physical download or transfer. In the PLR, the Department confirms that these transactions are not subject to Kentucky sales and use tax because there is no transfer or sale of tangible personal property. Contrast this with the purchase of prewritten computer software via physical copy, for example, on a CD or thumb drive, which involves the transfer of tangible personal property and which is thus taxable. While this PLR is fact-specific and issued to a specific taxpayer, it does provide a helpful look at the Department's view of SaaS transactions.

Cryptocurrency

In 2021, Kentucky enacted some tax laws to encourage cryptocurrency mining. As a state, Kentucky is attractive to cryptocurrency miners because of comparatively low electricity rates.

Cryptocurrency like Bitcoin is becoming more mainstream. But, many people still shy away from it, perhaps because they do not get it. Perhaps a concise primer may be helpful?

In a nutshell, "Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." IRS Notice 2014-16, I.R.B. 938 (2014). "In brief, the Bitcoin system is a public ledger. It denotes who owns each unit of Bitcoin available. Transactions amount to debiting one address and crediting another. And public key cryptography ensures transactions are secure." William J. Luther, Demystifying Bitcoin (Feb. 15, 2017). The public ledger is known as the "blockchain." A cryptocurrency "miner" uses "computer resources to validate Bitcoin transactions and maintain the public...transaction ledger." IRS Notice 2014-16. Cryptocurrency exchanges facilitate cryptocurrency transactions.

Cryptocurrency is property for federal income tax purposes, according to the IRS. So, "General tax principles applicable to property transactions apply to transactions using virtual currency." IRS Notice 2014-16. "[W]hen a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income." *Id.* Income resulting from mining cryptocurrency would be self-employment income. *Id.*

Through provisions in H.B. 230 and S.B 255, Kentucky has provided for sales and use tax exemptions for electricity and tangible personal property directly used in the commercial mining of cryptocurrency. The exemption is obtained through application and the exemption is effective as of the date of approval. This exemption went into effect on July 1, 2021, with a 4-year sunset. The exemption is available at revenue.ky.gov/Forms/51A900%20(9-21).pdf.

Evolution of the KBTA

The Kentucky Board of Tax Appeals has evolved as a result of Kentucky Senate Bill 162, enacted in early 2021. The KBTA still consists of a three-member panel, each appointed by the Governor; however, they are now subject to Senate confirmation. To qualify as a member of the Board, two members must be attorneys having the same qualifications required of candidates for a Circuit Judge with one having a background in taxation. The Chair, who is designated by the Governor, must be an attorney. Notably, SB 162 also expanded the exclusive jurisdiction of the KBTA to hear and determinate appeals from final rulings, orders, and final determinations of any revenue and taxation agency which affects review and taxation, with all appeals being heard by the full board; this includes appeals from "any agency of state, county, and local government, including special taxing districts.

Tax laws are constantly evolving and changing. There is always something new. It is one of the most challenging and interesting thing about taxes. One should take a minute to stop and look around so one does not miss anything!

This is a modified version of Mark A. Loyd's regular column, *Tax in the Bluegrass*, "Big Kentucky Tax Issues Facing Businesses" which appeared in Issue 1, 2022 of the Kentucky CPA Journal.

STATE AND LOCAL TAX TEAM

Mark A. Loyd
Chair, Tax Department
mark.loyd@dentons.com

Bailey Roese
Partner
bailey.roese@dentons.com

Brett J. Miller
Partner
brett.miller@dentons.com

Stephanie Bruns
Senior Managing Associate
stephanie.bruns@dentons.com

Jeffrey T. Bennett
Partner
jeff.bennett@dentons.com

Brad Hasler
Partner
bradley.hasler@dentons.com

Kelli A. Wikoff
Partner
kelli.wikoff@dentons.com

Kimberly M. Nolte
Associate
kimberly.nolte@dentons.com

Gary R. Thorup
Shareholder
gary.thorup@dentons.com

Eric Smith
Of Counsel
eric.smith@dentons.com

Ronald Aulbach
Shareholder
ronald.aulbach@dentons.com

Sarah Franklin
Shareholder
sarah.franklin@dentons.com

Michael Gilmer
Special Counsel
michael.gilmer@dentons.com

Sidney Jackson
Associate
sidney.jackson@dentons.com

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