Kentucky General Assembly Passes Significant Changes to Kentucky's Tax Code

ARTICLE 04.03.18 DEAN DORTON

After vigorous debate on the floors of both the Kentucky Senate and House of Representatives, on Monday, April 2, the General Assembly passed the Free Conference Committee Substitute for HB 366. The bill, which might be called "Tax Reform Lite," makes significant changes to Kentucky's tax code, but many argue there is much reform left to be done.

The bill raises Kentucky's cigarette tax by 50 cents to $1.10 per pack and includes changes to Kentucky's individual and corporation income taxes, sales and use tax, and one small, but important change, to the state's property taxes. Additionally, the bill limits and suspends some existing tax credits and incentives. Here is a brief look at a few of the more significant provisions of the bill.

Individual income tax

- In large part, changes made in December to the federal tax code are incorporated into the state tax code. The primary exception is Kentucky will not adopt the increased expensing and depreciation provisions for capital improvements.
- The current graduated tax system, with rates ranging from 2% to 6%, is converted to a flat rate of 5% for all taxpayers effective for tax years beginning on or after January 1, 2018.
- The personal credit of $10 per person is repealed.
- For taxpayers that itemize deductions, the only itemized deductions that will be allowed are deductions for mortgage interest and charitable contributions. All other itemized deductions, that is, deductions for the cost of medical insurance, medical expenses, local occupational taxes and property taxes paid, interest expense on investments, casualty and theft losses, and other miscellaneous deductions are eliminated.
- Long-term care and health insurance premiums allowed previously as a deduction from Kentucky adjusted gross income are no longer allowed.
- Historically, Kentucky has permitted $41,110 per person of pension income to be excluded from taxable income. With this bill, that exclusion is reduced to $31,110 per person. Social Security continues to be fully exempted from Kentucky income tax.

Corporation income tax

- As with the individual income tax, the corporation income tax is conformed to the federal tax code as amended in December. Again, the primary exception is Kentucky will not adopt the increased expensing and depreciation deductions for capital improvements.
- Similar to the recent federal changes, the deduction for domestic production activities is eliminated.
- The current graduated tax system, with a top rate of 6%, is converted to a flat rate of 5% for all taxpayers effective for tax years beginning on or after January 1, 2018.
- Companies that do business in Kentucky and other states will apportion their income to Kentucky using a single-factor apportionment formula, as opposed to the current three-factor apportionment formula. The sales factor for service entities will now be computed based on market-sourcing as opposed to the current cost of performance methodology.

Property taxKentucky is one of only a handful of states that imposes a property tax on business inventory. The bill attempts to "phase-out" this tax by allowing a *non-refundable* income tax credit of 25% for taxes paid in 2018 and increasing the credit by 25% each year until there is a 100% credit for taxes paid on business inventory for years beginning on or after January 1, 2021. Stated otherwise, the property tax will remain, because of its importance to local governments, but taxpayers will receive a non-refundable credit against their state income tax for the inventory tax they pay.Sales and use tax

Effective for transactions occurring on or after July 1, 2018, the bill imposes sales and use tax for the first time on the following:

- Labor and services associated with the repair, installation, and maintenance of taxable tangible personal property;
- Extended warranties;
- Landscaping and lawn care services;
- Janitorial services;
- Pet care (small animal) veterinarian services;
- Industrial laundry services;
- Dry cleaning and laundry services;
- Linen supply services;
- Pet grooming and boarding services;
- Diet and weight-reducing services;
- Tanning services;
- Limousine services; and
- Admissions to campsites, campgrounds, recreational vehicle parks, bowling centers, skating rinks, health spas, swimming pools, tennis courts, weight training facilities, fitness and recreational sports centers, golf courses, and country clubs.

The bill repeals the sales tax exemption for pollution control facilities for transactions occurring on or after July 1, 2018.

Credits and incentivesThe Kentucky Industrial Revitalization Tax Credit, Kentucky Investment Fund Tax Credit, and Kentucky Angel Investor Tax Credit are suspended for four years to provide time for the General Assembly to study the impact of the credits. Also, the film tax credit, which has been subject to negative press, is retained but limited by the bill.Revenue estimatesThe tax bill is estimated to provide additional revenue of $234.1M in fiscal year 2019 and $244.1M in fiscal year 2020. Much debate took place in the House as to the accuracy of these estimates.ConclusionThe Tax Foundation, a leading independent tax policy research organization, has stated the changes instituted by HB 366 will move Kentucky from 33rd to 18th on the State Business Tax Climate Index published by the Foundation.

In that case, a constitutional majority (51 votes in the House and 20 votes in the Senate) could override the Governor’s veto.

If you have any questions, please contact your Dean Dorton advisor or Erica Horn at ehorn@deandorton.com.