

Enacted Kentucky legislation provides for mandatory combined reporting for unitary businesses and additional sales tax changes

Overview

Effective April 27, 2018, Kentucky House Bill 487 (H.B. 487)¹ was enacted into law without Governor Matt Bevin's signature. H.B. 487 incorporates many of the changes that were previously implemented by House Bill 366 (H.B. 366),² and includes the following additional modifications to Kentucky tax law:

- Mandatory combined reporting for unitary businesses, effective for taxable years beginning on or after January 1, 2019.
- An election to file a consolidated state return based on the federal filing group, effective for taxable years beginning on or after January 1, 2019.
- Extension of a three-factor apportionment formula to certain communications, cable, and internet access service companies for taxable years beginning on or after January 1, 2018.
- Decouples from IRC Section 199A for taxable years beginning on or after January 1, 2018.
- Expansion of sales tax manufacturing exemption for transactions occurring on or after July 1, 2018.

This tax alert summarizes these changes and provides some taxpayer considerations.

Mandatory combined filing for unitary businesses

For taxable years beginning on or after January 1, 2019, H.B. 487 mandates that all taxpayers engaged in a unitary business group with one or more corporations must file a combined report in the state.³ H. B. 487 outlines how apportionable and taxable income are to be calculated for combined reporting purposes, and requires single sales factor apportionment and market-based sourcing as previously enacted in H. B. 366. Kentucky net operating losses will be computed with respect to each group member and carried forward against Kentucky source positive net income of such member.⁴ Note that the taxable income for a combined group is the sum of taxable income of each group member as determined under federal law and adjusted for state purposes as if the members are not consolidated for federal purposes.⁵ A combined group must include the entire income and apportionment factor of any member that is doing business in a tax haven.⁶ Income from intercompany transactions between members of the combined group are deferred under the principles of Treas. Reg. § 1.1502-13.⁷

In lieu of combined reporting, taxpayers may elect to file a Kentucky consolidated return based on their federal affiliated group.⁸ A consolidated filing election will be binding for eight (8) years.⁹ If a consolidated filing election is made, a

¹ 2018 Regular Session (H.B. 487). A copy of the law is accessible [here](#).

² 2018 Regular Session (H.B. 366). For additional details on H.B. 366, see our previously issued MTS tax alert, available [here](#).

³ H.B. 487, Sec. 120(3). Note that under current law, taxpayers with nexus in Kentucky that are in an includible chain of corporations with a common parent than also has nexus in the state are required to file a nexus consolidated return. All other taxpayers with nexus in the state that are not in an includible chain of corporations must file a separate return.

⁴ H.B. 487, Sec. 120(5)(a)7.

⁵ H.B. 487, Sec. 120(4).

⁶ H.B. 487, Sec. 120(8).

⁷ H.B. 487, Sec. 120(8)(e).

⁸ H.B. 487, Sec 119(2), (3).

⁹ H.B. 487, Sec. 119(3).

Kentucky affiliated group is treated for all purposes as a single corporation.¹⁰ All intercompany transactions must be eliminated in computing net income and in determining the apportionment factor.¹¹

Extension of three-factor apportionment formula for certain taxpayers

Under H.B. 366, Kentucky adopted a single sales factor formula for its general apportionment formula for taxable years beginning on or after January 1, 2018. Pursuant to H.B. 487, a “provider” will continue to apply a three-factor apportionment formula for taxable years beginning on or after January 1, 2018.¹² A “provider” is defined as any corporation engaged in the business of providing a communications service, cable service, or internet access.¹³

Decoupling from IRC Section 199A

H.B. 487 requires an addback of the 20% pass through entity deduction provided in IRC Section 199A for taxpayers other than corporations for taxable years beginning on or after January 1, 2018.¹⁴

Sales and use tax amendments

H.B. 487 makes several important changes to Kentucky sales and use tax. For transactions occurring on or after July 1, 2018, Kentucky exempts from sales and use tax “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” provided that the charges are separately stated on an invoice, bill of sale, or other similar document given to the purchaser.¹⁵ The bill also expands the manufacturing exemption to include tangible personal property directly used in connection with “industrial processing,” which is a newly defined term.¹⁶ H.B. 487 further expands the definition of cost of production for purposes of the sales tax manufacturing and industrial processing exemptions to include all inputs directly used in an integrated manufacturing process, including labor.¹⁷

H.B. 487 also amends the definition of “prewritten computer software” to clarify that the combining of two or more prewritten computer software programs (or portions thereof) does not cause the combination to be “other than prewritten computer software.”¹⁸ Furthermore, the definition excludes custom modifications or enhancements of prewritten computer software unless there is a “reasonable, separately stated charge on an invoice or other statement of the price to the purchaser for the modification or enhancement.”¹⁹

H.B. 487 incorporates the sales tax changes previously made by H. B. 366, including the expansion of the sales tax base with respect to certain enumerated services and imposition of economic nexus provisions on remote sellers.

Additional changes

Additional administrative and specialty tax amendments resulting from the enactment of H.B. 487 include the following:

- Increasing the deadline to notify the state of federal audit changes from 30 days to 180 following the federal determination date.²⁰
- Eliminating the 50% limitation on consolidated NOL utilization for taxable years beginning on or after January 1, 2019.²¹

¹⁰ H.B. 487, Sec. 119(4)(b).

¹¹ *Id.*

¹² H.B. 487, Sec. 78(3).

¹³ H.B. 487, Sec. 78(1)(e).

¹⁴ H.B. 487, Sec. 55(1)(n).

¹⁵ H.B. 487, Sec. 121(23).

¹⁶ H.B. 487, Sec. 121(9).

¹⁷ H.B. 487, Sec. 44(3)(b).

¹⁸ H.B. 487, Sec. 36(29)

¹⁹ *Id.*

²⁰ H.B. 487, Sec. 114(4). Note that H.B. 366 had previously increased the deadline to 90 days.

²¹ H.B. 487, Sec. 79(11)(c).

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- Mandating an electronic filing for corporate and pass-through entities with one million dollars or more of gross receipts as reported on their federal income tax return for taxable years beginning on or after January 1, 2019.²²
- Providing that computer software, except prewritten computer software, will be exempt from state and local ad valorem taxable beginning on January 1, 2019.²³ The bill defines prewritten computer software in the same manner for property tax purposes as it is for sales tax purposes.²⁴

Considerations

H.B. 487, along with the previously enacted H.B. 366, contain significant changes that may impact taxpayers doing business in Kentucky. Taxpayers should review the effects the new laws created by the two bills may have on their state tax obligations in Kentucky with regard to the updated conformity to the IRC provided in H.B. 366, mandatory combined reporting, apportionment factor changes and the expanded sales and use tax nexus provisions. Taxpayers should consider whether electing to file a Kentucky consolidated return is a more advantageous option than mandatory combined reporting. Taxpayers without a physical presence in Kentucky should also be mindful of the new “economic nexus” sales tax provisions contained in H.B. 366, particularly in light of the United States Supreme Court’s decision to grant *certiorari* in the *Wayfair* case.²⁵ Taxpayers potentially impacted by the enactment of H.B. 487 or H.B. 366 should consult with their Kentucky tax advisors for further assistance.

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If you have questions regarding H.B. 366, H.B. 487, or other Kentucky tax matters, please contact any of the following Deloitte Tax professionals:

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²² H.B. 487, Sec. 117(2)(g).

²³ H.B. 487, Sec. 122(1).

²⁴ H.B. 487, Sec. 122(2), Sec. 36(29)(a).

²⁵ A decision in *Wayfair* is expected to be issued in the summer of 2018. However, the decision may be rendered after July 1, 2018, when the new Kentucky economic nexus sales tax provisions become effective.