

Kentucky Tax Alert

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Income Tax Relief for Small Businesses

On June 28, 2006, the Kentucky General Assembly enacted House Bill 1 during an unprecedented five-day Special Session. The bill was signed into law by Gov. Fletcher the same day. The following is a summary of the main provisions of HB 1:

Small Business Alternative Minimum Calculation (AMC) Relief—Effective for Taxable Years Beginning on or After Jan. 1, 2006, and Before Jan. 1, 2007

Effective for taxable years beginning on or after Jan. 1, 2006, and before Jan. 1, 2007, the AMC is not due from a corporation if the corporation's gross receipts or gross profits from all sources are \$3 million or less. This relief applies to limited liability companies (LLCs), S corporations, limited liability partnerships, limited partnerships and C corporations.

Effective for taxable years beginning on or after Jan. 1, 2006, and before Jan. 1, 2007, the AMC is partially reduced for taxpayers with gross receipts or gross profits from all sources in excess of \$3 million, but less than \$6 million. The reduction in the AMC due is based upon one of two formulas, depending on whether the AMC is calculated on gross receipts or gross profits.

1. $\text{Ky. Gross Receipts} \times .00095$
Minus $\$2,850 \times \frac{\$6,000,000 - \text{Ky. Gross Receipts}}{\$3,000,000}$
2. $\text{Ky. Gross Profits} \times .0075$
Minus $\$22,500 \times \frac{\$6,000,000 - \text{Ky. Gross Profits}}{\$3,000,000}$

Taxpayers who receive the threshold AMC relief still owe the \$175 minimum tax due for tax years beginning on or after Jan. 1, 2006, and before Jan. 1, 2007, provided that the \$175 minimum is greater than the regular income tax or AMC amount.

Restoration of Federal Pass-through Entity Treatment for Taxable Years Beginning on or After Jan. 1, 2007

For taxable years beginning on or after Jan. 1, 2007, all pass-through entities will be treated the same for Kentucky income tax purposes as they are treated for federal income tax purposes except for differences between Kentucky law and federal law. This treatment is sometimes referred to as federal conformity. LLCs, S corporations, limited liability partnerships and limited partnerships will no longer be taxed at the entity level under the corporation income tax. The income will be passed through and taxed at the ownership level.

For taxable years beginning on or after Jan. 1, 2005, and before Jan. 1, 2007, pass-through entities remain subject to the corporation income tax imposed by KRS 141.040 unless the entity is specifically exempted under KRS 141.040(1).

The bill requires withholding of the income tax due from nonresident individual owners of pass-through entities and from corporate owners of pass-through entities if the corporate owner's only business connection to Kentucky is the ownership interest in a pass-through entity doing business here. This change applies to taxable years beginning on or after Jan. 1, 2007.

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Income Tax Relief (Continued from page 1)**Top Corporation Income Tax Rate Reduction—Effective for Taxable Years Beginning on or After Jan. 1, 2007**

The current law, which reduces the top corporation income tax rate to 6 percent, remains unchanged. This rate drop from 7 percent remains effective for taxable years beginning on or after Jan. 1, 2007.

New Limited Liability Entity Tax Replaces AMC—Effective for Taxable Years Beginning on or After Jan. 1, 2007

Effective for taxable years beginning on or after Jan. 1, 2007, a limited liability entity (LLE) tax is imposed on corporations and limited liability pass-through entities except those entities that are exempted by subsection (6) of Section 4 of HB 1. The entities exempt from the LLE tax are listed at the end of this section. A minimum of \$175 will be due from those entities subject to this new tax.

Except for the \$175 minimum, the LLE tax will not apply if the entities' gross receipts or gross profits from all sources are \$3 million or less.

Except for the \$175 minimum, the LLE tax will be partially reduced for taxpayers with gross receipts or gross profits from all sources in excess of \$3 million, but less than \$6 million. The reduction in the LLE tax due is based on one of two formulas, depending on whether the LLE tax is calculated on gross receipts or gross profits.

1. $\text{Ky. Gross Receipts} \times .00095$
 Minus $\$2,850 \times \frac{\$6,000,000 - \text{Ky. Gross Receipts}}{\$3,000,000}$
2. $\text{Ky. Gross Profits} \times .0075$
 Minus $\$22,500 \times \frac{\$6,000,000 - \text{Ky. Gross Profits}}{\$3,000,000}$

Entities that are exempted from the LLE tax are:

1. Financial institutions, as defined in KRS 136.500, except banker's banks organized under KRS 287.135 or 286.3-135;

2. Savings and loan associations organized under the laws of this state and under the laws of the U.S. and making loans to members only;
3. Banks for cooperatives;
4. Production credit associations;
5. Insurance companies, including farmers' or other mutual hail, cyclone, windstorm or fire insurance companies, insurers and reciprocal underwriters;
6. Corporations or other entities exempt under Section 501 of the Internal Revenue Code (IRC);
7. Religious, educational, charitable or like corporations not organized or conducted for pecuniary profit;
8. Corporations whose only owned or leased property located in this state is located at the premises of a printer with which it has contracted for printing, provided that:
 - a. the property consists of the final printed product, or copy from which the printed product is produced; and
 - b. the corporation has no individuals receiving compensation in this state as provided in KRS 141.120(8)(b);
9. Public service corporations subject to tax under KRS 136.120;
10. Open-end registered investment companies organized under the laws of this state and registered under the Investment Company Act of 1940;
11. Any property or facility that has been certified as a fluidized bed energy production facility as defined in KRS 211.390;
12. An alcohol production facility as defined in KRS 247.910;
13. Real estate investment trusts as defined in Section 856 of the IRC;
14. Regulated investment companies as defined in Section 851 of the IRC;
15. Real estate mortgage investment conduits as defined in Section 860D of the IRC;
16. Personal service corporations as defined in Section 269A(b)(1) of the IRC;
17. Cooperatives described in Sections 521 and 1381 of the IRC, including farmers' agricultural and other cooperatives organized or recognized under KRS Chapter 272, advertising cooperatives, purchasing cooperatives, homeowner's associations including those described in Section 528 of the IRC, political

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organizations as defined in Section 527 of the IRC, and rural electric and rural telephone cooperatives; or

18. Publicly traded partnerships as defined by Section 7704(b) of the IRC that are treated as partnerships for federal tax purposes under Section 7704(c) of the IRC or their publicly traded partnership affiliates. "Publicly traded partnership affiliates" shall include any LLC or limited partnership for which at least 80 percent of the LLC member interests or limited partner interests are owned directly or indirectly by the publicly traded partnership.

New Limited Liability Entity Tax is a Credit Against Income Tax—Effective for Taxable Years Beginning on or After Jan. 1, 2007

Any corporation that is subject to the corporation income tax and LLE tax may use the LLE tax due as a credit against the corporation income tax. This credit is reduced by the \$175 minimum tax due and is nonrefundable. The credit shall not be carried forward to future periods.

An individual, limited liability pass-through entity or corporation that owns a percentage of a limited liability pass-through entity will receive as a nonrefundable credit, a proportionate share of the LLE tax paid by the limited liability pass-through entity. This pass-through credit may be used against individual income tax, corporation income tax or LLE tax depending on the type of ownership. The amount of credit passed through will be reduced by the \$175 minimum tax due. The credit allowed to members, shareholders or partners of a limited liability pass-through entity shall only be applied to income tax due on income from the limited liability pass-through entity.

Other Credits Against the LLE Tax—Effective for Taxable Years Beginning on or After Jan. 1, 2007

As with the AMC, the economic development tax credits, e.g., KREDA, KIRA, etc., may be used against

the LLE tax liability. Also, other income tax credits, e.g., recycling and biodiesel credits may be used against the LLE tax liability.

Apportionment

A multistate pass-through entity that is doing business within and without Kentucky will pass through its proportionate share of its receipts, property and payroll to its corporation ownership to be included in the corporation's apportionment factor. A general partnership formed after Jan. 1, 2006 that is doing business within and without Kentucky will pass through its proportionate share of receipts, property and payroll to its corporation ownership to be included in the corporation's apportionment factor.

Homeowner's Associations

Any homeowner's association that is required to file a federal income tax return on Form 1120H is required to file a Kentucky corporation income tax return on Form 720. That statement does not reflect a law change, but rather a continuation of the Department of Revenue's (DOR) long-standing interpretation of Kentucky's corporation income tax law. KRS 141.010(14)(c) defines *taxable net income* in the case of a homeowner's association. If no income is taxable on the federal Form 1120H, no income is taxable on the Kentucky return.

For taxable years beginning on or after Jan. 1, 2005, and before Jan. 1, 2007, a homeowner's association that meets the definition of corporation in KRS 141.010(24) will be subject to the \$175 minimum tax due if the greater of its income or AMC calculations results in a tax due of less than \$175.

Homeowner's associations will be exempt from the LLE tax, including the \$175 minimum tax for taxable years beginning on or after Jan. 1, 2007.

Certain Sales of Motor Vehicles Subject to Sales Tax

HB 380 provides an amendment to KRS 139.470(21) regarding the sales tax exemption on sales of motor vehicles as follows:

- (a) *Sold to a Kentucky resident, registered for use on the public highways, and upon which any applicable tax levied by KRS 138.460 has been paid; or*
- (b) *Sold to a nonresident of Kentucky if the nonresident registers the motor vehicle in a state that:*
 - 1) *allows residents of Kentucky to purchase motor vehicles without payment of that state's sales tax at the time of sale; or*
 - 2) *allows residents of Kentucky to remove the vehicle from that state within a specific period for subsequent registration and use in Kentucky without payment of that state's sales tax.*

Effective Aug. 1, 2006, sales of motor vehicles in Kentucky to residents of states that do not meet the exemption criteria listed above are subject to Kentucky sales tax. This provision serves to equalize the taxation of motor vehicles based upon how other states handle motor vehicles purchased by Kentucky residents in their jurisdictions. This law change will not alter the amount of state tax a customer ultimately pays on the purchase of a motor vehicle. For example, if a nonresident pays Kentucky sales tax for a motor vehicle purchased in our state, this customer should receive a credit against any



additional state sales and use tax due in the customer's state of residence.

Indiana residents are the only customers from a border state that does not provide Kentucky residents the treatment required for the exemption. Residents from other states that do not qualify for the exemption are as follows: Arizona, California, Florida, Massachusetts, Michigan, South Carolina and Washington. **The impact of this legislation is that Kentucky car dealers, who make sales in this state to residents of any of these eight states, must collect Kentucky sales tax for transactions on or after Aug. 1, 2006. The receipts and tax should be reported and paid with the filing of the dealer's regular sales and use tax return.**

In addition to the Kentucky sales and use tax return, a supplemental sales tax schedule must be filed listing only those sales to nonresidents (from the above eight states) on which the Kentucky sales tax was due. This supplemental schedule is to provide a breakdown of the portion of the total sales and use tax reported on a dealer's sales tax return that specifically relates to sales of motor vehicles to these nonresident customers. The DOR will compile the information from these schedules and make the appropriate transfers of these collections into the Road Fund as required in the provisions of HB 380. If you need additional information on this topic, contact the Taxpayer Assistance Branch of the Division of Sales and Use Tax at (502) 564-5170.



Gasoline Excise Tax Rate



Under KRS 138.210 and KRS 138.220, the DOR is responsible for establishing the average wholesale price (AWP) of gasoline for the purposes of calculating the gasoline excise tax rate. The current price calculation is based on sales data accumulated for the month of April 2006 and a grade and formulation weighted average reflecting gasoline consumption patterns. For the quarter commencing July 1, 2006, the DOR has determined the AWP of gasoline increased to \$1.476. Therefore, the rate is now 19.7 cents per gallon for gasoline and 16.7 cents per gallon for special fuels and is inclusive of the 1.4 cents Petroleum Storage Tank Environmental Assurance Fee. Additionally, the rate for liquefied petroleum increased to 18.3 cents per gallon.

State Property Tax Rate Set at 12.8 Cents for 2006

The DOR has set the 2006 state real property tax rate at 12.8 cents per each \$100 of assessed value. KRS 132.020 requires the DOR to set the real property rate by July 1 of each year.



This rate is based on the percentage increase of taxable real property from 2005 to 2006. If this increase is more than 4 percent after the exclusion of property newly added to the tax roll during 2006, then the prior year rate must be reduced to limit the revenue increase to 4 percent. Since the assessment increase for 2006 is estimated at 6.6 percent, the state rate must decline from 13.1 to 12.8 cents per \$100 of assessed value.

Kentucky Tax Alert comments and suggestions should be addressed to the Office of Public Information, Finance Secretary's Office, Frankfort, Kentucky, (502) 564-9165, ext. 4500.

ERNIE FLETCHER, Governor

JOHN FARRIS, Secretary
Finance and Administration Cabinet

MARIAN DAVIS, Commissioner
Department of Revenue

Editor Jill Midkiff
Production/Design Support Services
Publications Coordinator Sarah Gilkison

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