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Accountants and Consultants

Subject:

Kentucky Makes Significant Changes to Tax Code

State Tax Alert

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Date/Timing:

A comprehensive tax bill, signed by the Governor, has significantly reformed the Kentucky tax code. Of particular importance, the legislation updates the I.R.C. conformity date to December 31, 2004, requires corporate taxpayers to pay the greater of the corporate income tax or an alternative minimum calculation based on gross receipts or gross profits, imposes an expanded nexus standard for corporate income and sales and use tax, lowers the top corporate and personal income tax rates, mandates nexus consolidated filing, repeals the corporate license tax, and prohibits the deduction for certain related party expenses, among other changes. (H.B. 272, Signed by the Governor on March 18, 2005).

Details:

Federal Conformity:

Updates the I.R.C. conformity date to incorporate the I.R.C. as in effect on December 31, 2004 (including the American Jobs Creation Act of 2004), and excluding "bonus" depreciation and increased I.R.C. Sec. 179 expensing.

Income Tax/Alternative Minimum Tax:

Corporations - Taxpayers are now subject to the greater of the new alternative minimum tax, the minimum tax, or income tax. Effective for tax years beginning on or after January 1, 2005, taxpayers who are subject to the corporation income tax are now subject to an alternative minimum tax calculation equal to the lesser of:

- 9.5 cents per \$100 of gross receipts measured by total sales in Kentucky divided by total sales everywhere; or
- 75 cents per \$100 of the taxpayer's Kentucky gross profits, defined as Kentucky gross receipts reduced by returns and allowances, less the cost of goods sold.

Corporate Income Tax Rate Schedule –

- 4 percent of the first \$50,000 of taxable net income;
- 5 percent of taxable net income over \$50,000 up to \$100,000; and
- 7 percent of taxable net income over \$100,000.
- The top rate of 7 percent is reduced to 6 percent for taxable years beginning on or after January 1, 2007.

Individuals - The top personal income tax rate of 6 percent is imposed on net income over \$75,000, rather than the current amount of \$8,000, for taxable years beginning after December 31, 2004. Net personal income from \$8,000 to \$75,000 is taxed at a new rate of 5.8 percent.

Minimum Tax:

A minimum tax of \$175 must now be paid by taxpayers subject to the corporation income tax, regardless of any tax credits for which the business may qualify.

Corporation License Tax:

The corporation license tax imposed on corporations and S corporations has been eliminated effective for tax periods ending on or after December 31, 2005. The repeal of the tax does not affect any returns and reports, outstanding tax liability, penalty, interest, or other obligation attributable to tax periods prior to December 31, 2005.

Nexus Standards:

The definition of "doing business" in Kentucky is expanded to the limits imposed by the U.S. Constitution and P.L. 86-272. Doing business in Kentucky includes the previous elements of organizing a business under state laws, maintaining a domicile in the state, or having property in the state, plus:

- Having one or more individuals performing services in the state;
- Maintaining an interest in a general partnership doing business in the state;
- Deriving income from or attributable to sources within the state, including deriving income directly or indirectly from a trust doing business in the state; or
- Directing activities at Kentucky customers for the purpose of selling them goods or services.

Entity Level Tax on Pass-Through Entities:

The definition of "corporations" subject to income tax is expanded to include S corporations, LLCs, LLPs, REITs, RICs, REMICs, financial asset securitization investment trusts (FASITs), and other limited liability entities. Publicly traded partnerships treated as partnerships for federal tax purposes and their affiliates are excluded from the definition.

Add-Back of Interest and Intangible Expenses:

Effective for tax years beginning on or after January 1, 2005, a taxpayer subject to the corporation income tax is limited to the amount deducted for intangible expenses and prohibited from deducting intangible interest expenses or management fees directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one

or more direct or indirect transactions with one or more related members of an affiliated group or with a corporation organized under the laws of a foreign country.

Corporate Apportionment Provisions:

A common four-factor apportionment formula consisting of property, payroll, and a double-weighted sales factor is applied to all business income, including the net income of general or qualified investment partnerships doing business in Kentucky that are not subject to an entity-level income tax.

NOL Provisions:

Corporation and personal income taxpayers are not allowed an NOL carry-back deduction for losses incurred for taxable years beginning on or after January 1, 2005.

Consolidated Returns:

Members of an affiliated group doing business in the state that are connected through stock ownership, membership interest, or partnership with a common parent must file a consolidated return if the common parent or any member of the group has 80 percent direct or indirect control of the group. Certain corporations are excluded from the requirement, including REITs, RICs, S corporations, and corporations that realize an NOL whose Kentucky apportionment factors are de minimis.

Composite Returns:

General partnerships doing business in Kentucky may file a composite income tax return on behalf of electing nonresident individual partners that reports and pays income tax at the highest marginal rate on the partners' pro rata or distributive share of the partnership's income.

Please note that these are just the changes that we felt were of utmost importance. Please refer to H.B. 272 for the additional changes made to the Kentucky tax code.

FOR MORE INFORMATION
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