WHITE PAPER
Tax Incentives for Business Location and Expansion

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THE KENTUCKY BUSINESS INVESTMENT PROGRAM

SUMMARY

As incentives to the location or expansion of an economic development project in the state, the Kentucky Business Investment Program allows a business which is engaged in manufacturing, agribusiness, nonretail service or technology, or national or regional headquarters operations and which satisfies minimum investment, job creation, and wage and employee benefit requirements to claim for up to fifteen years a credit against up to 100% of its state income tax liability arising from the project and to withhold during the same period and retain up to 5% of the wages of its employees whose jobs are created as a result of the project. The total amount of the incentives claimed may not exceed the total costs incurred to acquire, construct, and equip the project. The amounts withheld from their wages may be claimed by the employees as full credit against the withholding taxes they would otherwise owe to the state and local taxing jurisdictions.

THE DETAILS

Introduction

A new tax incentive program for eligible businesses locating or expanding in Kentucky, known as the Kentucky Business Incentive Program (KBI), was enacted in 2009 and consolidates several business incentives programs previously in effect.[1] KBI can reduce or eliminate the state income liability of an eligible business, and reduce its payroll expense, for up to fifteen years after the new or expanded business commences operations in the state.

Like the previous state economic development incentive programs which the new program replaces, the business community and the general public view KBI as a cost-effective means of attracting new and expanded economic activity. The benefits are targeted to economic development projects that would not have been undertaken in Kentucky but for the availability of the state tax incentives. The state forbears temporarily from collecting tax revenues it would not have received at all if the business

[1] The statute is codified at KRS Chapter 154.32, available online at http://www.lrc.state.ky.us/KRS/154-32/CHAPTER.HTM.

had not been induced to locate or expand within the state, to make a substantial new capital investment within the state, and to create a significant number of well-paying jobs for Kentucky residents.

As was the case with the previous state economic development incentive programs, KBI is administered by the Kentucky Economic Development Finance Authority (KEDFA), an agency within the Kentucky Cabinet for Economic Development (KEDC) composed of six private citizens with experience in business or finance appointed by the Governor and, *ex officio*, the Secretary of the Kentucky Finance and Administration Cabinet.

Eligible Companies and Eligible Business Activities

A company eligible for incentives under KBI (*an eligible company)* includes any corporation, limited liability company, partnership, limited partnership, sole proprietorship, business trust, or any other entity with a proposed *economic development project* (as defined below) that is engaged in or is planning to be engaged in one or more of the following activities within the Commonwealth of Kentucky (*an eligible business activity*):

- Manufacturing;
- Agribusiness;
- Nonretail service or technology; or
- National or regional headquarters operations, regardless of the underlying business activity of the company.

"Manufacturing" means any activity involving or relating to the processing, assembling, or production of any property and includes storage, warehousing, distribution, and office activities related to the manufacturing activity.

"Agribusiness" means the processing of raw agricultural products, including timber, or the performance of value-added functions with regard to raw agricultural products.

A "nonretail service or technology" activity must be (a) designed to serve a multistate, national, or international market and more than 50% of the services must be provided to customers outside of Kentucky or (b) provided by a national or regional headquarters as a support to other business activities conducted by the eligible company. Nonretail service or technology includes but is not limited to call centers, centralized administrative or processing centers, telephone or Internet sales order or processing centers, distribution or fulfillment centers, data processing centers, research and development facilities, and other similar activities.

A company is not eligible for incentives under KBI if its primary activity to be conducted within Kentucky is forestry, fishing, mining, coal or mineral processing, the provision of utilities, construction, wholesale trade, retail trade, real estate, rental and leasing, educational services, accommodation and food services, or public administration services.

Eligible Economic Development Projects

An *economic development project* eligible for incentives under KBI means the acquisition, leasing, or construction and equipping of a new facility to be used by an eligible company for an eligible business activity or the acquisition, leasing, rehabilitation, or expansion and equipping of an existing facility to be used by an eligible company for an eligible business activity. Subject to the following exceptions, an eligible economic development project does not include any project that will result in the replacement of existing facilities in the Commonwealth.

KEDFA may approve as an eligible economic development project a project which rehabilitates an existing facility used for an eligible business activity if the facility has not been in operation for a period of 90 or more consecutive days or the current occupant of the facility has advertised a notice of closure and the eligible company proposing the economic development project is not an affiliate of the current occupant of the facility.

KEDFA may approve as an eligible economic development project a project which replaces an existing facility used for an eligible business activity if:

- the facility is sold or transferred pursuant to a foreclosure ordered by a court of competent jurisdiction or an order of a bankruptcy court of competent jurisdiction and title to the facility prior to the sale is not vested in the eligible company or an affiliate of the eligible company;
- the facility has been or is being condemned by governmental authority and normal operations at the facility cannot be resumed within 12 months;
- the facility has been damaged or destroyed by fire or other casualty to the extent that normal operations cannot be resumed at the facility within 12 months; or
- the facility replaces an existing facility located in the same county if the existing facility cannot be expanded due to the unavailability of real estate at or adjacent to the facility to be replaced, but in such a case incentives under KBI are available only to the extent of the expansion and incentives are not allowed for the equivalent of the facility being replaced.

KEDFA may not approve an economic development project for incentives under KBI which results in the abandonment or termination of an existing lease without the consent of the lessor.

Enhanced Incentive Counties

As described below, the minimum wage requirements and the extent of the available incentives under the Kentucky Business Incentive Program vary according to whether an eligible economic development project is located in an enhanced incentive county[2]. A county is an *enhanced incentive county* if (a) its average annual unemployment rate in the five preceding calendar years exceeded the average annual unemployment rate of the state during those years; (b) its unemployment rate for the preceding calendar year was more than 200% of the statewide unemployment rate for such year; or (c) KEDFA certifies that the county is one of the 60 most distressed counties in the state (out of the state's total of 120 counties) based on its average rate of unemployment during the three most recent consecutive calendar years, the percentage of the residents of the county 25 years of age and older who have not attained a high school education or the equivalent, and the quality of the roads in the county.

Once a project located in an enhanced incentives county receives final approval for KBI incentives as described below, it continues to be eligible for enhanced incentives even if the county subsequently ceases to be an enhanced incentives county. A project which has received preliminary approval for KBI incentives as described below will remain eligible for enhanced incentives if it receives final approval by July 1 of the third year following the county's decertification as an enhanced incentives county.

Minimum Requirements for Eligible Economic Development Projects

To be eligible for KBI incentives, an economic development project must satisfy the following minimum requirements:

Minimum Investment

The eligible company must incur eligible costs (as defined below) for its economic development project of at least $100,000.

Minimum New Employment

The economic development project must create a minimum of 10 new, full-time (at least 35 hours per week) jobs for Kentucky residents and must maintain an annual average of 10 new, full-time jobs for Kentucky residents.

Minimum Wages and Benefits

For projects in enhanced incentive counties, at least 90% of the new employees must receive base hourly wages of at least 125% of the federal minimum wage[3]. For projects in other counties, at least 90% of the new employees must receive base hourly wages of at least 150% of the federal minimum wage.

All the new employees must be entitled to employee benefits equal to at least 15% of the minimum wage target (as defined below) or, alternatively, total hourly compensation (wages and benefits) equal to at least 115% of the minimum wage target. For purposes of KBI, *employee benefits* means nonmandated payments for health insurance, life insurance, dental insurance, vision insurance, and defined benefit plans, profit sharing plans, 401(k) plans, or similar plans, but do not include bonuses, commissions, incentive pay, or any other contingent compensation.

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[2] A map of Kentucky showing which counties are currently enhanced incentive counties is available on the KEDC website at http://www.thinkkentucky.com/kyedc/pdfs/KREDA_Counties.pdf.

[3] The federal minimum wage is currently $7.25 per hour.

“But For” Requirement

For new projects locating in Kentucky, the company must certify that its economic development project could reasonably and efficiently locate outside of Kentucky and without the incentives offered under KBI the project will likely locate outside of Kentucky.

For economic development project involving the expansion of an existing facility in Kentucky, the company must certify that the incentives are necessary for the project to occur.

Eligible Costs

Costs incurred by an eligible company for an eligible economic development project are *eligible costs* and may be recovered through the company’s receipt of KBI incentives only after KEDFA adopts a resolution granting preliminary approval of the company and the project.

For owned projects (as defined below), *eligible costs* include (a) start-up costs (as defined below) and (b) costs of acquiring land or rights in land and related costs, including recording fees; cost of payment and performance bonds, builder’s risk insurance, and other insurance required during the construction of the project; costs of labor and amounts paid to contractors, subcontractors, builders, and materialmen in connection with the project; costs of construction, including site tests and inspections; subsurface site work; excavation; removal of structures, roadways, cemeteries, and other surface obstructions; filling, grading, and providing drainage and storm water retention facilities; installation of utilities such as water, sewer, sewage treatment, gas, electric, communications, and similar facilities; off-site construction of utility extensions to the boundaries of the project site; construction and installation of railroad spurs needed to connect the project to existing railways; and similar costs which KEDFA determines are necessary for construction of the project.

For leased projects (as defined below), *eligible costs* include start-up costs and 50% of the estimated annual rent.

“*Start-up costs*” mean costs incurred to furnish and equip a facility for an economic development project, including costs incurred for computers, furnishings, office equipment, manufacturing equipment, and fixtures; the relocation of out-of-state equipment to the project site; and nonrecurring costs of fixed telecommunications equipment.

For all projects that are not located in enhanced incentive counties, the cost of equipment eligible for incentives as an eligible cost is limited to $20,000 for each new full-time job created as of the activation date of the project (as defined below).

Economic development projects are classified for purposes of KBI as an owned project or a leased project. An *owned project* means an economic development project owned in fee simple by the eligible company or an affiliate, or possessed by the eligible company or an affiliate pursuant to a capital lease. A capital lease means a lease classified as a capital lease by Statement of Financial Accounting Standards No. 13, Accounting for Leases, issued by the Financial Accounting Standards Board, November 1976, as amended (“SFAS 13”). A *leased project* means an economic development project occupied by the company pursuant to a lease classified under SFAS 13 as an operating lease.

Incentives

Income Tax Credits

A company approved by KEDFA for the receipt of KBI incentives (an *approved company)* receives each year a 100% credit against the Kentucky income tax that would otherwise be payable on the taxable income generated by its economic development project. A company receiving KBI tax credits is exempt from the payment of quarterly estimated state income tax.

In the case of an approved company that pays Kentucky state corporation income tax (a C corporation for federal income tax purposes) or Kentucky limited liability entity tax (an S corporation for federal income tax purposes, or a limited liability partnership, or limited liability company, that is not publicly traded), the credit is claimed against the company's state corporation income tax liability or state limited liability entity tax liability. In the case of a company that does not pay Kentucky state corporation income tax or limited liability entity tax (a sole proprietorship, a general partnership, a publicly traded limited partnership, or a publicly traded limited liability company), the credit is claimed against the Kentucky personal income tax liability of the sole proprietor, the partners of the general partnership, the partners of the publicly traded limited partnership, or the members of the publicly traded limited liability company.

Wage Assessments

In addition to state income tax credits, an approved company may withhold and retain up to 5% of the gross wages of each employee whose job was created as a result of an economic development project in an enhanced incentive county or up to 4% (including up to 1% of any local occupational license tax) as a result of an economic development project in all other counties. The amounts withheld are known as *wage assessments.*

Employees of a project in an enhanced incentive county may claim the 5% withheld from their wages as a credit against their Kentucky personal income tax liability. Employees of a project in other counties may claim the 3% portion of the amount withheld from their wages as a credit against their Kentucky personal income tax liability and the remaining up to 1% portion of the amount withheld from their wages as a credit against their local occupational license tax liability.

As a condition to the approval of incentives under the Kentucky Business Investment Program for an economic development project located in a county other than an enhanced incentive county, the city or county where the project is located must agree to allow a credit against the occupational license taxes the county or city would otherwise collect from the wages of the employees whose jobs are created by the project. If the county and city both impose an occupational license tax, the amount withheld and the credit allowed is prorated between them. If neither the county nor the city where the project is located imposes a local occupational license tax, the local jurisdictions must provide some alternative inducement satisfactory to KEDFA (e.g., a contribution of land for the project) in order for the project to be approved for incentives under KBI, unless KEDFA determines that the local jurisdictions are unable to provide a reasonable inducement.

Duration of the Incentives

The approved company may claim income tax credits and withhold wage assessments for up to fifteen years, for projects in an enhanced incentive county, or up to 10 years, for projects in all other counties, until the sum of the income tax credits received and the wage assessment withheld equal the total *confirmed approved costs* (as defined below) of the company's economic development project.

Application and Approval Process

A company seeking state incentives for the location or expansion of a business in Kentucky should contact the Kentucky Cabinet for Economic Development (KEDC). A KEDC staff member will be assigned as project manager to determine the incentives for which the project may qualify and to assist the company with its application. The company must complete and file with KEDFA an application form, together with a brief history of the business and description of the proposed economic development project, a letter endorsing the project from the county judge or mayor of the county or city where the project will be located, a financial statement for the company's most recent fiscal year, and a nonrefundable application fee of $1,000. The completed application must be received by the last Friday of the month in order to be considered for preliminary approval at the following month's KEDFA meeting.

Because of the "but for" requirement described above, any public announcement or legal commitment towards the project (such as entering into a lease, land or equipment purchase contract, or construction contract), if not expressly conditioned upon KEDFA's approval of the incentives, may jeopardize the eligibility of the project for incentives under the Kentucky Business Incentive Program.

Prior to KEDFA's consideration of the application, the company and KEDC staff negotiate the annual average number of new full-time jobs (at least 10) that the company will commit to create and maintain at its economic development project (the *jobs target*) and the average minimum wage amount, including employee benefits, that the company will commit to meet for all the new full-time jobs created and maintained as a result of the economic development project (the *minimum wage target*), which may not be less than 125% of the federal minimum wage in enhanced incentive counties or less than 150% of the federal minimum wage in all other counties, and the total maximum amount and annual maximum amount of eligible costs approved for recovery by the company through its receipt of KBI incentives (the *approved costs*).

The criteria applied by KEDFA for reviewing and approving the application include the creditworthiness of the company, the amount of the proposed capital investment, the number of new full-time jobs to be created by the project for Kentucky residents and the wages to be paid, the local community's support of the project, and the likelihood of the economic success of the project.

If KEDFA adopts a resolution granting preliminary approval, the company and KEDFA execute a memorandum of agreement setting forth the preliminary jobs target, minimum wage target, and approved costs for the company's project and the company may begin to incur expenditures and hire new employees for the project. The company has one year from the date of the preliminary approval to negotiate a *tax incentive agreement* with KEDC setting forth the final jobs target, minimum wage target, and approved costs for the project and the date (the "*activation date*"), which may be no later than two years after KEDFA's final approval of the project, by which the company expects to be able to certify and document to KEDFA that it has incurred the approved costs and reached its jobs target and minimum wage target. KEDFA may then adopt a resolution granting final approval of the project and authorizing its execution of the tax incentive agreement with the company. An administrative fee equal to one-quarter of one percent (.025%) of the approved costs, up to a maximum of $50,000, is payable by the company to KEDFA upon execution of the tax incentive agreement.

Following the execution of the tax incentive agreement, the company must certify and document to KEDFA the approved costs it has incurred prior to the activation date (the "*confirmed approved costs*"), which may be less than but not more than the approved costs set forth in the tax incentive agreement, and the extent to which it has reached its job target and minimum wage target by the activation date. Subject to possible reduction, suspension, or termination of the incentives as described below if it has not reached those targets by the activation date, beginning on the activation date the company may withhold the wage assessments from the wages of its new employees at the project and may claim KBI income tax credits against the income generated by the project.

Each year during the term of the tax incentive agreement (15 years for projects in enhanced incentive counties and 10 years for projects in other counties), the company must certify and document to KEDFA the extent to which it has reached or maintained its jobs target and minimum wage target and, in the case of leased projects, the amount of rent paid for the lease of the project.

The amount of incentives claimed (the sum of the wage assessments and income tax credits) may not in any year exceed the annual maximum amount of incentives authorized under the tax incentive agreement nor exceed the total maximum amount of incentives authorized under the tax incentive agreement (or, if less the confirmed costs of the project).

Termination, Suspension, or Reduction of Incentives

If the company fails to satisfy as of the activation date the minimum investment requirement, the minimum new jobs requirement, or the minimum wage requirement, the tax incentive agreement terminates and the company ceases to be eligible for KBI incentives. If the minimum requirements were satisfied as of the activation date but are not satisfied upon any subsequent annual review by KEDFA of the company's performance under the tax incentive agreement, KEDFA may suspend the company's receipt of incentives until the minimum requirements are again satisfied or may terminate the tax incentive agreement and the company's right to any further KBI incentives.

A company will be entitled to receive 100% of the annual maximum amount of the incentives authorized under its tax incentive agreement for the following year if it achieves 90% or more of its jobs target and its minimum wage target upon KEDFA's annual review of its performance. If the company fails to achieve at least 90% of its jobs target or minimum wage target, the company's annual maximum amount of incentives for the following year is reduced by the same percentage as the percentage shortfall in the jobs target or the minimum wage target. If both targets are missed, the annual maximum amount of incentives for the following year is reduced by the same percentage as the percentage shortfall in either the jobs target or the minimum wage target, whichever was greater.

PROPERTY TAX ABATEMENT VIA AN INDUSTRIAL REVENUE BOND ISSUE[4]

Regardless of whether the interest on an industrial revenue bond ("**IRB**") issue will qualify for exemption from federal income tax, the issuance of an IRB to finance the establishment or expansion of a manufacturing, processing, warehouse, distribution, or other industrial facility in Kentucky can be used to obtain abatement of property taxes on the facility financed by the bond issue for the duration of the bond issue. Kentucky law allows a city or county, or KEDFA, to issue industrial revenue bonds to finance the acquisition, construction, and equipping of an industrial facility and to lease the land, building, and equipment comprising the industrial facility (the *project*) to a private company for use in its business operations.

The city, county, or KEDFA, issuing the bonds (the *issuer*) leases the project to the company for a term equal to the term of the bonds (which may be up to 30 years) in return for rental payments by the company equal to (and applied to) the principal and interest payable on the bonds.

The lease provides that upon the full payment and retirement of the bonds by the company at maturity or earlier redemption, the issuer is required to convey the project to the company for no additional consideration other than possibly a nominal payment to the issuer (e.g., $100) as agreed at the outset of the lease. The lease therefore constitutes a financing arrangement rather than a true lease for tax purposes so that the company may claim depreciation on the project for federal and state income tax purposes as well as deducting the interest the company pays on the bonds.

Kentucky law provides that, with the approval of KEDFA, property financed by an IRB and leased by the issuer to the company is exempt from state and local property tax as long as the bonds remain outstanding and title to the property is held by the issuer. Once the bonds are paid and retired and title to the project is conveyed by the issuer to the company, the property becomes subject to full state and local property taxation.

Because only the value of the property financed by the IRB is eligible for property tax exemption, it is to the company's advantage to maximize the principal amount of the IRB so that the entire cost of the project is regarded as having been financed by the IRB. If the company does not require external financing for all or some portion of the cost of the project (i.e., it intends to pay all or a portion of the cost of the project with its own funds or funds provided by its parent company or some other affiliate), full property tax abatement through IRB financing can nevertheless be achieved by having an affiliate of the company (e.g., its parent corporation), rather than a bank or other external lender, purchase the bonds.

[4] The Kentucky Industrial Revenue Bond Act, KRS Chapter 103, is online at www.lrc.state.ky.us/KRS/103-00/CHAPTER.HTM. Fact sheets for the Kentucky IRB program, including the procedure for approval of property tax abatement through an IRB and whom to contact for further information, is available at the KEDC website:
www.thinkkentucky.com/kyedc/pdfs/IRB_2005.pdf
and www.thinkkentucky.com/kyedc/pdfs/irbprocedures.pdf

To obtain KEDFA's approval for property tax abatement through an IRB, the issuer (if it is not KEDFA itself) and the company jointly file an application with KEDFA at least 45 days prior to the proposed issuance date of the IRB, together with a non-refundable $500 application fee payable by the company to KEDFA. KEDFA applies the following criteria in evaluating the application: the number of new full-time jobs to be created or preserved by the project and the average salary for those jobs; the amount of the company's capital investment in the project, including the principal amount of the IRB; the unemployment rate in the county where the project will be located; the state tax incentives, grants or loans applied for or obtained for the project; the new tax revenues expected to be generated by the project over the term of the proposed IRB issue; the amount of state and local property tax abatement for which KEDFA's approval is sought; and evidence that the city, county, school district and any other local taxing districts where the project will be located support the project.

The city, county, school district, and any other local taxing districts where the project will be located may require, as a condition to their support of the project, that the company agree to make payments in lieu of taxes ("**PILOTs**") equal to all or some portion of the property tax payments that the company would be required to pay were it not for the statutory exemption of the IRB-financed property from such taxes. The PILOT agreement most often required by the local jurisdictions is that the company agree to pay the school taxes that would otherwise be due with respect to the project. However, jurisdictions with high local unemployment and eager for local economic development will often forego requiring PILOTs as an additional inducement to the location of the proposed project in their jurisdiction.

If KEDFA approves the property tax abatement requested by the issuer and the company, the project will be subject as long as the IRB is outstanding only to any PILOTs the company has agreed to pay and an annual state tax at the nominal rate of 0.015% on the value of the company's leasehold interest in the project. For a multimillion dollar project, this property tax abatement via an IRB issue can be a substantial inducement for a company to undertake the project within Kentucky.

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