



Kentucky Sales Tax Facts

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Each edition of the Department of Revenue sales and use tax newsletter seeks to provide taxpayers with assistance in the filing of returns and the application of sales tax laws and regulations. The contents of this informational bulletin shall not take precedence over any existing laws or regulations of the commonwealth. Your comments and suggestions are welcomed. Please help us serve you better.

STREAMLINING KENTUCKY'S SALES TAX CODE—PART II

This issue is the second in a series highlighting the upcoming changes to Kentucky's sales and use tax law resulting from the Streamlined Sales and Use Tax Act enacted by the 2003 Kentucky General Assembly as part of House Bill 293. This Kentucky legislation is part of a nationwide effort by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration so that Main Street merchants as well as remote sellers can more easily comply with the tax requirements of the various jurisdictions into which their products are sold. At this time there are 42 states and the District of Columbia actively participating in the Streamlined Sales Tax Project. The changes for Kentucky discussed below will take effect July 1, 2004.

Exempt Grocery Food

The current sales and use tax exemption for food items under KRS 139.485 has been in effect since 1972. Many states have a sales and use tax exemption for food primarily to relieve the tax burden on those who spend a relatively large portion of their income on grocery food. However, the definition of what constitutes food for tax purposes is different in every state, and many of the administrative rules developed over time regarding this issue in Kentucky are difficult to apply and need updating to address current sales and consumption patterns in the market place. The changes to this statute take effect July 1, 2004, and apply the uniform definition structure adopted by the Streamlined Sales Tax Project.

The complete new version of KRS 139.485 can be found at www.lrc.state.ky.us/krs/139-00/485.pdf. Under this amendment, the term food and food ingredients means substances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. Excluded from the exempt food and food ingredients are the subcategories of (a) alcoholic beverages, (b) tobacco, (c) candy, (d) dietary supplements, (e) soft drinks, and (f) prepared food. Each of these subcategories is defined as well to provide clear direction on what products do not constitute exempt food and food ingredients. Below is a further discussion of some of these terms to illustrate the application of the new guidelines.

Candy

Candy means a preparation of sugar, honey, or other natural or artificial sweeteners in combination with chocolate, fruits, nuts, or other ingredients or flavorings in the form of bars, drops, or pieces. Candy shall not include: 1) any preparation containing flour; or 2) any item requiring refrigeration. This definition should make

it easier to determine when a product fits the candy definition and falls outside the exempt food category. Items that previously seemed to be in a gray category between exempt cookies and taxable candy now belong outside the candy definition if they contain flour as a labeled ingredient. Also, ice cream fits the food category even when including sugar, honey, or other *candy* ingredients because of the required refrigeration. Examples of common products within the candy category are chewing gum, candy bars, marshmallows, breath mints, caramel corn, chocolate or carob covered raisins, honey roasted nuts, fruit roll-ups, etc.

Soft Drinks

Soft drinks mean nonalcoholic beverages that contain natural or artificial sweeteners. Soft drinks do not include beverages that contain milk or milk products, soy, rice, or similar milk substitutes, or greater than 50 percent of vegetable or fruit juice by volume. There are obviously many products on the market that sell as fruit or vegetable juices; however, to meet the definition of food these products must contain more than 50 percent vegetable or fruit juice. Beverages that contain less than the required threshold belong in the nonexempt soft drink category. One major effect of adopting this guideline is the reclassification of unflavored bottled water into the nontaxable food category. By combining a broad general definition with specific exclusions, the soft drink definition includes a wide variety of beverages beyond just carbonated beverages. Other examples of taxable soft drinks are coffee and tea drinks, sports drinks, and fruit ades.

Prepared Food

Creating a *prepared food* definition addresses the entire gamut of questions involving deli sales by grocers, bulk food issues, baked goods, and restaurant sales. The law taking effect July 1, 2004, defines prepared food as follows:

1. Food sold in a heated state or heated by the retailer;
2. Two or more food ingredients mixed or combined by the retailer for sale as a single item except food that is only cut, repackaged, or pasteurized by the retailer; eggs, fish, meat, poultry, and foods containing these raw animal foods requiring cooking by the consumer as recommended by the Food and Drug Administration in Chapter 3, Part 401.11 of the FDA Food Code so as to prevent food borne illnesses; or
3. Food sold with eating utensils provided by the retailer, including plates, knives, forks, spoons, glasses, cups, napkins, or straws.

However, *prepared food* shall not include the following items if sold without eating utensils provided by the seller:

1. Food sold by a seller whose proper primary North American Industry Classification System (NAICS) classification is manufacturing in sector 311 (food manufacturing), except subsector 3118 (bakeries); or
2. Bakery items, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danishes, cakes, tortes, pies, tarts, muffins, bars, cookies, and tortillas.

The overall impact of the prepared food definition is to clarify that in general food items prepared and sold by the seller to the consumer are taxable. The preparation by the seller may occur where the food is sold or at another location. All products sold in a heated state are taxable. Prepared food includes items that were heated by the seller and are ready to eat without further cooking by the purchaser. Food shall be considered sold with eating utensils provided by the seller when food is intended for consumption with the utensils the seller provides. Therefore, food sold by businesses that sell meals such as restaurants, caterers, sandwich shops, snack bars, concession stands, etc., suitable for consumption on or off the premises comes under the nonexempt prepared food category regardless of the temperature or quantity of the product sold. Examples of taxable food prepared by the seller with or without eating facilities are rotisserie chicken, sandwiches, party trays, salads, meatloaf, casseroles, and salad bar products.

However, food items sold by a retailer whose primary NAICS classification is 311 food manufacturing, excluding subsector 3118, are not taxable prepared food unless sold with eating utensils. In the case where a manufacturer packages eating utensils with the food but is not the direct retailer of the food items, the product is not a taxable prepared food. The category of eating utensils does not include packaging merely used to transport food products. Also, the new language provides an exclusion from the prepared food category for bakery items. Therefore, cakes, pies, donuts, and other pastry items prepared and sold by the grocer or stand-alone bakery items are exempt, provided the baked goods are not sold with eating

utensils supplied by the seller. This guideline applies regardless of the quantity or serving size of baked goods sold (no more six donut rule!).

Other Categories

All food items sold through vending machines remain taxable regardless of the subcategory classification. Also, sales of alcoholic beverages and tobacco products subject to Kentucky sales and use tax are unchanged with the adoption of the Streamlined Sales Tax definitions. Food or food products purchased for human consumption through the food stamp program administered by the U.S. Department of Agriculture are exempt as well.

Sourcing Sales Transactions

Sourcing rules provide guidelines on determining the location of the sale so that retailers can determine which jurisdiction's tax to charge. You may access the new sourcing guidelines codified under KRS 139.105 at www.lrc.state.ky.us/krs/139-00/105.pdf. This statute takes effect on July 1, 2004. In many states sales tax is due on both the state and local levels; however, since Kentucky has only a state-based sales and use tax, sourcing issues primarily relate to multi-state transactions. For example, what tax should an out-of-state retailer charge for products delivered to a customer in Kentucky? The commonwealth currently treats the retail sale of products into the state as subject to Kentucky tax. Kentucky's adoption of the new sourcing rules will not change the taxability of products delivered into the state because the new guidelines merely confirm our existing destination-based sourcing for sales of tangible personal property and taxable services. In addition, the new statute includes the sourcing of telecommunications services, some of which were previously addressed in the current version of KRS 139.100, under the discussion of service address in subsection four. Since every state participating in the Streamlined Sales Tax Project must adopt these sourcing rules, this change represents tremendous progress in developing uniformity and simplicity in the administration and compliance of both state and local sales and use taxes.

If the Streamlined Sales and Use Tax Act affects your business in these areas, make applicable changes to your accounting and reporting records and systems by the July 1, 2004, effective date. Also, watch for additional highlights of these significant legislative reforms in upcoming issues of *Kentucky Sales Tax Facts*. If you need further assistance with any of these topics, contact the Department of Revenue, Sales and Use Tax Branch at (502) 564-5170 or via e-mail at KRCWebResponseSalesTax@ky.gov.

This newsletter is intended to provide practical information to assist persons in fulfilling their sales and use tax obligations to the commonwealth. To submit additional questions or suggestions for future topics, please write to: *Kentucky Sales Tax Facts*, Sales and Use Tax, Station 53, P.O. Box 181, Frankfort, KY 40602-0181 or call (502) 564-5170, fax (502) 564-2041, Web site www.revenue.ky.gov.

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