

Kentucky Tax Alert

A REVENUE PUBLICATION FOR THE TAX PROFESSIONAL

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Tax Modernization a Reality for Kentuckians

On Mar. 18, 2005, Gov. Fletcher signed House Bill 272 to reform Kentucky's outdated tax system. The legislation, passed by the Kentucky Senate and House on March 8, begins the first comprehensive overhaul in decades to a revenue system largely based on a 19th century economy.

The top income tax rate will be reduced to 5.8 percent from 6 percent on income from \$8,000 to \$75,000. That was about a third of the reduction sought by Gov. Fletcher. But the reform will result in 216,000 low-income tax filers, representing 496,000 total Kentuckians, being removed from the income tax rolls.

The top income tax rate on corporations, currently 8.25 percent, will be cut to 7 percent this year and then down to 6 percent in 2007. Gov. Fletcher had proposed an immediate drop to 6 percent.

The legislation also closes some business tax loopholes, including the exemption for corporations that do business—but have no “physical presence”—in Kentucky. Legislators concurred with the governor that the exemption has been unfair to Kentucky companies. It also will treat all businesses the same, regardless of the form of organization.

Another benefit of the legislation includes a tuition tax credit of up to \$500 for Kentuckians with children in Kentucky's postsecondary educational institutions, public or private. More than 61,000 families are expected to qualify for this assistance.



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New Fraud Detection and Collection Efforts by DOR

As a cornerstone of his administration, Gov. Fletcher has stressed the commitment to eliminate waste, fraud and abuse within state government and throughout the commonwealth. In keeping with this vision, the DOR has stepped up efforts to identify fraudulent returns and nonfilers.

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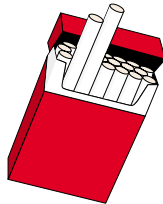
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Tax Modernization

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Other tax credits are created for historic preservation; biodiesel, which will reduce air pollution; and brownfields development, which will help our cities by slowing the loss of green space to development and eliminating the potential health risks associated with blight.



The excise tax on cigarettes, which at 3 cents was the lowest in the nation and had never been increased, will be increased to 30 cents a pack, with part of the revenue dedicated to cancer research at the University of Louisville and the University of Kentucky.

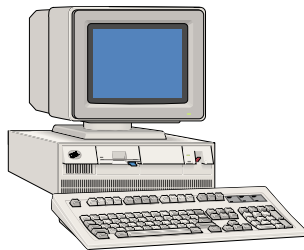
A development fund for equine breeders will help preserve Kentucky's status as the horse capital of the world—a status that has been endangered by aggressive incentive programs in other states.

The corporate license tax and the “intangible property” tax on accounts receivable and bonds will be repealed. Experts say these two taxes are the biggest impediment to economic development in Kentucky.

More information will be available on these tax reform issues in the May edition of **Kentucky Tax Alert** or by accessing the DOR's Web site at www.revenue.ky.gov.

DOR Posts Delinquent Taxpayers on Web Site

The Kentucky Finance and Administration Cabinet's Department of Revenue (DOR) has posted on the Internet the names and amounts owed to the commonwealth of the top 500 most delinquent Kentucky taxpayers. To view this listing of the 250 most delinquent individuals and the 250 most delinquent businesses, visit the DOR's Web site at www.revenue.ky.gov.



Kentucky is now the 14th state to post delinquent taxpayer information on the Internet. Currently Colorado, Connecticut, Georgia, Indiana, Louisiana, Maryland, Massachusetts, Minnesota, New Jersey, North Carolina, Rhode Island, South Carolina, Washington and the District of Columbia also publish such lists and have achieved considerable success using this method.

“This administration is committed to collecting what is owed to the state, not increasing the tax burden on people who are already paying their share,” Finance and Administration Cabinet Secretary Robbie Rudolph said. “If we can collect even a portion of what is owed, which we estimate to be in the hundreds of millions of dollars, we will have done what is right for the law abiding taxpayers of this commonwealth.”

Individuals who have additional information about the delinquent taxpayers listed on the DOR's Web site may now submit an anonymous tip at <http://revenue.ky.gov/fraud.htm>. Individuals who choose to include their contact information may do so, but it is not required.

Kentucky's list will be regularly updated and expanded to include a larger number of delinquent taxpayers over time. Businesses and individuals who believe they may owe past due taxes and wish to keep their names off the delinquent taxpayer Web site should contact the DOR at (502) 564-4921, ext. 5367.

New Fraud Detection

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Using new technologies to locate and identify potential fraud cases, the DOR is dedicating additional resources to operate fraud detection and collection efforts in addition to already existing compliance programs. The DOR will be using data, tips and techniques obtained from other state agencies and the Internal Revenue Service to track down would be civil and criminal cases. In addition, the DOR will be working in cooperation with other local and state agencies to make sure these compliance efforts assist all taxing agencies within the commonwealth to help stamp out fraud and abuse.

Some of the areas that are being looked into include:

- Off Shore Tax Shelters
- Electronic Filing Schemes
- Employment Tax Fraud
- Sham Transactions Between Companies
- Tax Protestors
- 501-C3 Fraud
- Cigarette Tax Evasion
- Sales Tax Fraud
- Cold Check Cases

If you would like to provide a tip of a specific fraudulent act or have any information on possible schemes being advertised by organizations or consultants, please contact the DOR at (502) 564-0169.

Gasoline Excise Tax Rate

Under KRS 138.210 and 138.220, the DOR is responsible for establishing the average wholesale price (AWP) of gasoline for the purpose of calculating the gasoline excise tax rate. The current price calculation is based on sales data accumulated for the month of January 2005 and a grade and formulation weighted average reflecting gasoline consumption patterns.

For the quarter commencing April 1, 2005, the DOR has determined the AWP of gasoline will remain \$1.22. Therefore, the rate will remain 17.4 cents per gallon for gasoline and 14.4 cents per gallon for special fuels and is inclusive of the 1.4 cent Petroleum Storage Tank Environment Assurance Fee. Additionally, the rate for liquefied petroleum remains at 16.0 cents per gallon.

**Reminder to
Electronic Return Originators**

Electronic Return Originators (ERO) are reminded not to mail Form 8453-K to the DOR. The following guidelines were established in March 2002.

Fed/State E-file with a federal PIN does not require Form 8453-K. The use of the federal PIN meets signature requirements for the Kentucky return. Online filing and Fed/State E-file returns without a federal PIN requires Form 8453-K, but the form does not need to be mailed to the DOR. Taxpayers must retain the form for a period of three years.

Contact the Electronic Filing Help Desk at (502) 564-5370, or any of our 10 taxpayer service centers throughout the state, with any questions or for additional information.

**New Kentucky Tax
Registration Application**

There is a revised application now available on the DOR's Web site, <http://revenue.ky.gov> that is easier for taxpayers and businesses to use. Click on **Business** on the left, then on **Register a Business and Kentucky Tax Registration Application**. It will soon be available in paper form.

Section A is the reason for filing the application and Section B identifies the business or organization. Once the questions in Section C are completed, you will know what other sections to complete and which tax account numbers (withholding, sales and use tax, consumer use tax and/or corporation income and license tax) you will need.



Beware of Tax Schemes

The Office of Taxpayer Ombudsman promotes *tax fairness*. Please be aware of the following tax schemes.

Persons who suspect tax fraud can call the IRS at 1-800-829-0433 or contact the Kentucky Department of Revenue (DOR) via the Web site at <http://revenue.ky.gov/fraud.htm>.



The Dirty Dozen

Reprinted from IRS News Release
[IR-2005-19, Feb. 28, 2005]

The IRS urges people to avoid these common schemes:

1. Trust Misuse. Unscrupulous promoters for years have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, some trusts do not deliver the promised tax benefits, and the IRS is actively examining these arrangements. More than two dozen injunctions have been obtained against promoters since 2001, and numerous promoters and their clients have been prosecuted. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.

2. Frivolous Arguments. Promoters have been known to make the following outlandish claims: that the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; that wages are not income; that filing a return and paying taxes are merely voluntary; and that being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Don't believe these or other similar claims. Such arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law.

3. Return Preparer Fraud. Dishonest return preparers can cause many headaches for taxpayers who fall victim to their ploys. Such preparers derive financial gain by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Taxpayers should choose carefully when hiring

a tax preparer. As the saying goes, if it sounds too good to be true, it probably is. No matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. Since 2002, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others, which are pending in court.

4. Credit Counseling Agencies. Taxpayers should be careful with credit counseling organizations that claim they can fix credit ratings, push debt payment agreements or charge high fees, monthly service charges or mandatory "contributions" that may add to debt. The IRS Tax Exempt and Government Entities Division has made auditing credit counseling organizations a priority because some of these tax-exempt organizations, which are intended to provide education to low-income customers with debt problems, are charging debtors large fees, while providing little or no counseling.

5. "Claim of Right" Doctrine. In this scheme, a taxpayer files a return and attempts to take a deduction equal to the entire amount of his or her wages. The promoter advises the taxpayer to label the deduction as "a necessary expense for the production of income" or "compensation for personal services actually rendered." This so-called deduction is based on a misinterpretation of the Internal Revenue Code and has no basis in law.

6. "No Gain" Deduction. Similar to "Claim of Right," filers attempt to eliminate their entire adjusted gross income (AGI) by deducting it on Schedule A. The filer lists his or her AGI under the Schedule A section labeled "Other Miscellaneous Deductions" and attaches a statement to the return, referring to court documents and including the words "No Gain Realized."

7. Corporation Sole. Since September 2004, the Department of Justice has obtained six injunctions against promoters of this scheme and filed complaints

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Beware of Tax Schemes

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against 11 others. Participants apply for incorporation under the pretext of being a “bishop” or “overseer” of a one-person, phony religious organization or society with the idea that this entitles the individual to exemption from federal income taxes as a nonprofit, religious organization. When used as intended, Corporation Sole statutes enable religious leaders to separate themselves legally from the control and ownership of church assets. But the rules have been twisted at seminars where taxpayers are charged fees of \$1,000 or more and incorrectly told that Corporation Sole laws provide a “legal” way to escape paying federal income taxes, child support and other personal debts.

8. Identity Theft. It pays to be choosy when it comes to disclosing personal information. Identity thieves have used stolen personal data to access financial accounts, run up charges on credit cards and apply for new loans. The IRS is aware of several identity theft scams involving taxes. In one case, fraudsters sent bank customers fictitious correspondence and IRS forms in an attempt to trick them into disclosing their personal financial data. In another, abusive tax preparers used clients’ Social Security numbers and other information to file false tax returns without the clients’ knowledge. Sometimes scammers pose as the IRS itself. Last year the IRS shut down a scheme in which perpetrators used e-mail to announce to unsuspecting taxpayers that they were “under audit” and could set matters right by divulging sensitive financial information on an official-looking Web site. Taxpayers should note the IRS does not use e-mail to contact them about issues related to their accounts. If taxpayers have any doubt whether a contact from the IRS is authentic, they can call 1-800-829-1040 to confirm it.

9. Abuse of Charitable Organizations and Deductions. The IRS has observed an increase in the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur, for example, when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income, thereby obtaining a tax deduction without transferring a commensurate benefit to charity. A “contribution” of a historic facade easement to a tax-exempt conservation organization is another example. In many cases, local historic preservation laws already

prohibit alteration of the home’s facade, making the contributed easement superfluous. Even if the facade could be altered, the deduction claimed for the easement contribution may far exceed the easement’s impact on the value of the property.

10. Offshore Transactions. Despite a crackdown on the practice by the IRS and state tax agencies, individuals continue to try to avoid U.S. taxes by illegally hiding income in offshore bank and brokerage accounts or using offshore credit cards, wire transfers, foreign trusts, employee leasing schemes, private annuities or life insurance to do so. The IRS, along with the tax agencies of U.S. states and possessions, continues to aggressively pursue taxpayers and promoters involved in such abusive transactions.

11. Zero Return. Promoters instruct taxpayers to enter all zeros on their federal income tax filings. In a twist on this scheme, filers enter zero income, report their withholding and then write “nunc pro tunc”—Latin for “now for then”—on the return.

12. Employment Tax Evasion. The IRS has seen a number of illegal schemes that instruct employers not to withhold federal income tax or other employment taxes from wages paid to their employees. Such advice is based on an incorrect interpretation of Section 861 and other parts of the tax law and has been refuted in court. Recent cases have resulted in criminal convictions, and the courts have issued injunctions against more than a dozen persons ordering them to stop promoting the scheme. Employer participants can also be held responsible for back payments of employment taxes, plus penalties and interest. It is worth noting that employees who have nothing withheld from their wages are still responsible for payment of their personal taxes.

13. Other Scams Still Linger. The IRS removed four scams from the Dirty Dozen this year: slavery reparations, improper home-based businesses, the Americans with Disabilities Act and EITC dependent sharing. The agency has noticed declines in activity in some of these schemes. But taxpayers should remain wary because the IRS has seen old scams resurface or evolve.

Moreover, the IRS reminds taxpayers to be vigilant about cons that may not be on the Dirty Dozen list. New tax scams or schemes routinely pop up, especially around tax time.

Court Case Updates

Property Tax—On Jan. 20, 2005, the Kentucky Supreme Court rendered an opinion in **Revenue Cabinet v. O’Daniel**, 2001-SC-1032 and **Revenue Cabinet v. Curtsinger**, 2002-SC-0204. This decision addressed the ad valorem tax liability of individuals who purchased motor vehicles in December 1994, but had not registered the vehicles in their names until after Jan. 1, 1995, as they were allowed to do under KRS 186A.095.

The Supreme Court ruled that the unambiguous language of the controlling statutory provisions (KRS 134.810(4) and 186.021(2)) placed the liability for the ad valorem taxes on the vehicles upon the owners *of record* on the Jan. 1, 1995, assessment date. In this case, the individuals in question did not register their vehicles until after the January 1 assessment and thus were not the owners *of record*, as of that date, who would be liable for the ad valorem taxes.

The outcome reached in this case is different from or contrary to the usual rule applicable to property taxes. See KRS 134.060(1). In addition, the ruling in this case is different from or contrary to the rule that presently governs the property tax on motor vehicles (“the MOTAX”) by virtue of legislation enacted in 2002 and applicable to assessments made on or after Jan. 1, 2003. 2002 Ky. Acts, Ch. 316 §1 and 3. The Supreme Court held in this case that “[a]lthough the Legislature amended the statutes in 2002 to comport with the [DOR’s] view that ownership for tax purposes occurs at the time of sale rather than at the time of registration, the amendment cannot be applied retroactively.”

The matter has been remanded to the Franklin Circuit Court for further proceedings and is not yet final.

On Feb. 17, 2005, the Franklin Circuit Court upheld a public service corporation ad valorem tax assessment in **Annox, Inc. v. Revenue Cabinet**, 03-CI-1605. The taxpayer, a switchless reseller of residential telephone service, contended the assessment violated the U.S.

Constitution’s Commerce and Due Process Clauses due to an alleged lack of a sufficient nexus between the taxpayer and the commonwealth.

The circuit court rejected the taxpayer’s arguments. The taxpayer had a substantial nexus with Kentucky as required by the Commerce Clause by virtue of its operating property in Kentucky, which consisted of the right under an interconnection agreement with Bell South to use Bell South’s lines, equipment and employees for a fee to provide telephone service to Kentucky customers. Bell South acted as the taxpayer’s independent contractor in Kentucky and Bell South’s activities were significantly associated with the taxpayer’s

ability to establish and maintain a market in Kentucky for its services. The taxpayer’s operating property in Kentucky also included a franchise in the form of a certificate of public convenience and necessity from the Kentucky Public Service Commission (PSC). This certificate was required by law for the taxpayer to provide telephone service in Kentucky. Finally, Congress had established a nexus between Kentucky and the taxpayer by the regulatory authority it had given the PSC in the Telecommunications Act of 1996 over interconnection agreements between Bell South and businesses such as the taxpayer.

The circuit court also ruled that there was a sufficient nexus between the taxpayer and Kentucky for purposes of the Due Process Clause. The taxpayer purposefully availed itself of the benefits of an economic market in Kentucky and the number of its customers (592), the income (\$333,243) derived from those customers and its contacts with Kentucky via its interconnection agreement with Bell South during the tax year in question were substantial enough with Kentucky that it had fair warning that its operating property would be subject to taxation by Kentucky.

This decision is not yet final. The taxpayer has appealed the circuit court’s decision to the Kentucky Court of Appeals.

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Court Case Updates

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On Mar. 2, 2005, the Kentucky Board of Tax Appeals (KBTA) ruled in **St. Andrew Orthodox Church, Inc. v. Jessamine County Property Valuation Administrator**; K03-S-08 and K04-S-61 that real property owned by the taxpayer, a church, was not exempt from ad valorem taxation under Section 170 of the Kentucky Constitution.

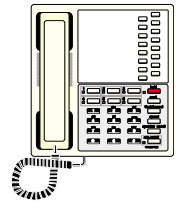
To be exempt, the real property had to be both owned and occupied by the church. The church rented the property to tenants to reduce the church's debt on the property. The KBTA found that the tenants occupied the property and not the church. The church's occasional use of the property for summer picnics and its use of the basement of one of the houses on the property to store its personal property did not constitute occupancy of the property within the meaning of the Constitution.

This decision is not yet final. The taxpayer has taken an appeal to the Jessamine Circuit Court.



Tax Refund Information Available by Phone

Information on Kentucky individual income tax refunds is available 24 hours per day through DOR's Automated Refund and Tax Information System (ARTIS). Call (502) 564-1600 from a touch-tone telephone to verify the DOR's receipt of the return or when the refund was mailed.



To use ARTIS, taxpayers must know the Social Security number listed first on the return, and the exact whole-dollar amount of the refund. Acknowledgment of receipt of a return is available for taxpayers using both labels provided by the DOR on their tax form packets. Labels are provided for the envelope and the tax return.

For taxpayers not using both labels, acknowledgment is not available until the return is processed. These taxpayers should wait 10 weeks after mailing their returns before calling ARTIS. Callers who do not receive a refund mailing date from ARTIS should wait seven days before calling again.

ARTIS is automatically available to all taxpayers filing their individual income tax returns electronically.

Utility Gross Receipts License Tax (School Tax)

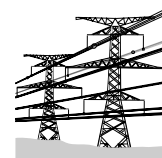
Effective July 1, 2005, the administration, distribution and compliance responsibilities of the utility gross receipts license tax will be transferred to the DOR.

The utility gross receipts license tax for schools is assessed on gross receipts derived from the furnishing of utility services and/or cable TV services within a school district. The utility companies collect the tax based on the rate established by the local authority and cannot exceed 3 percent. The utility company or an energy direct pay holder submits payment to the DOR with a breakdown of the tax collected by school district. The department captures the district information and the corresponding tax collections and distributes

the amount to the appropriate school district in one monthly payment.

Utility gross receipts license tax laws can be found under Chapter 160 of the Kentucky Revised Statutes.

For more information, contact the Department of Revenue, Financial Tax Section, by phone at (502) 564-4810, or by e-mail at *DOR.WebResponseFinancialTax@ky.gov*.



Foreign Income Is Now Tax Deductible

Is foreign income tax deductible on the 2004 individual return?

Yes, individual taxpayers may claim allowable foreign income taxes as an itemized deduction on returns filed for periods ending after June 30, 2004, which began before Jan. 1, 2005.

The provision of the 2003 budget bill, HB 269, that denied the deduction for foreign income taxes, effective for taxable years beginning after Dec. 31, 2002, expired June 30, 2004.

In the 2005 budget bill, HB 267, KRS 141.010(11) is amended to eliminate the deduction effective for taxable years beginning after Dec. 31, 2004. This provision is permanent, subject to future actions by the General Assembly.

The following list is included to show the range of taxable years in which the deduction is allowable:

Fiscal years beginning Aug. 1, 2003–ending July 31, 2004;

Calendar years beginning Jan. 1, 2004–ending Dec. 31, 2004; and

Fiscal years beginning Dec. 1, 2004–ending Nov. 30, 2005.

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