

Kentucky Tax Alert

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Additional Processing Tips and Common Errors

Following is a list of the most common errors appearing on 2003 Kentucky individual income tax returns. If errors are avoided, processing time is minimized and refunds, if due, are received more quickly.

- ➔ Tax practitioners should advise e-filers **not** to send a copy of their return with their payment. Use Form 740-V to mail a payment. The first return may be billed as if no payment has been received before the processing of the copy of the pay return is completed. The check should include the Social Security number(s) (SSN(s)) and the tax year.
- ➔ State copy of wage statements must be attached to the return. Failure to attach the wage statement verifying Kentucky withholding will delay the processing of the return. Do not claim local withholding as Kentucky withholding.
- ➔ Attach wage statements to only the top page of the return using two staples. Attach payments on top with one staple.
- ➔ Provide all of your clients with copies of the taxpayer's income tax return including copies of all applicable schedules and wage and tax statements.
- ➔ The SSNs are **not** on the preprinted labels. The SSNs must be entered in the appropriate boxes on the returns.
- ➔ It is important to use the preprinted labels as it speeds up processing and helps with accuracy.
- ➔ Changes in filing status may render the preprinted label unusable. For instance, if the filing status for the prior year was married filing jointly, and the current filing status is single, the use of the label may cause the refund to go out in both names.
- ➔ When applicable, use Form 2210-K, Underpayment of Estimated Tax by Individuals, to calculate any underestimated tax penalties or to claim a waiver of penalty. Check appropriate box on Form 740 when Form 2210-K is attached.
- ➔ If a pay agreement is needed, complete and attach Form 12A200, Kentucky Individual Income Tax Installment Agreement Request, (or a statement) to the front of the return.
- ➔ Error in calculating the Low Income Credit. The credit should be based on the Kentucky adjusted gross income.
- ➔ Failure to attach page 2 of the Kentucky Form 740.
- ➔ Error in amount claimed as the standard deduction of the Form 740 (not claiming enough—The amount is \$1,830 this year) or failure to take the standard deduction at all.
- ➔ Filing of the Kentucky Form 8453-K with the Kentucky Form 740 or 740-EZ to request direct deposit of refund. (This cannot be done. Only way to receive direct deposit is through electronic submission of return.)
- ➔ Duplicate copies of returns filed. This is true especially for those who file electronically and then submit a copy of their return.

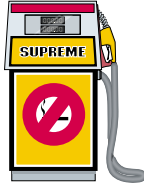
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Gasoline Excise Tax Rate

Under KRS 138.210 and 138.220, the Department of Revenue is responsible for establishing the average wholesale price 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 2004 and a grade and formulation weighted average reflected of gasoline consumption patterns.

For the quarter commencing April 1, 2004, the Department of Revenue has determined the average wholesale price of gasoline to be \$1.058. Therefore, the rate remains 16.4 cents per gallon, which includes the 1.4 cent Petroleum Storage Tank Environmental Assurance Fee.



New Administrative Regulation 103 KAR 26:120— Advertising Agencies

There is a new administrative regulation now in place for advertising agencies that became effective on Feb. 16, 2004. The regulation establishes needed guidelines for the proper application of sales and use tax on purchases and sales of tangible personal property. The new material provides clarifications regarding what types of activities constitute advertising services and when an advertising agency is to be treated as a retailer or a consumer. Interested parties may access the regulation online at www.lrc.state.us/kar/103/026/120.htm. For further assistance regarding these new regulatory provisions, call the Kentucky Department of Revenue at (502) 564-5170.

Voluntary Disclosure Program

The Kentucky Department of Revenue is committed to promoting taxpayer compliance. To accomplish this objective, the department would like to make you aware of our Voluntary Disclosure program. A Voluntary Disclosure Agreement (VDA) is available to taxpayers who want to comply with our tax laws. Information describing Kentucky's Voluntary Disclosure program can be found on the department's Web site at www.revenue.ky.gov. Go to Tax Professionals, Collections, and click on Voluntary Disclosure.

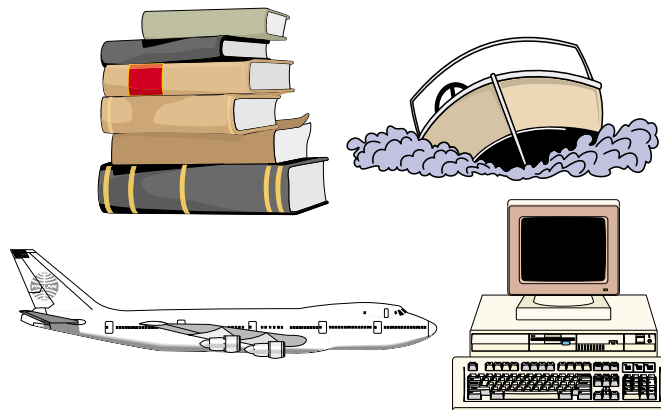
The Department of Revenue has several compliance programs in place to identify taxpayers who are not in compliance. A VDA **cannot be executed** with a taxpayer who has been previously audited or has been contacted by the Department of Revenue.

With income tax filing season underway, we would also like to remind you and your clients of the use tax responsibilities. KRS 139.310 and 139.330 impose use tax on those out-of-state purchases for storage, use, or other

consumption in Kentucky. Purchases of items such as aircraft, boats, artwork, jewelry, furniture, clothing, software, sporting goods, electronics, computers, books, and magazines are examples of personal items bought out of state that may be subject to Kentucky use tax.

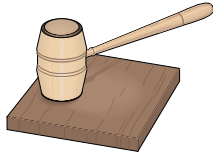
Use tax purchases may be reported by individuals on the Kentucky income tax return (740, line 23; 740-EZ, line 7; and 740-NP, line 19). Use tax may also be reported and paid on Form 51A113(O), available on the Web site at www.revenue.ky.gov. Businesses and entities registered for sales tax may report their use tax on line 23(a) of their Kentucky sales and use tax return.

If you have any questions about the Voluntary Disclosure program, call (502) 564-4921, ext. 4463, or, if you have questions about use tax, call (502) 564-5170. We look forward to working with you and your clients on state tax compliance issues.



Court Case Updates

Property Tax—On Feb. 5, 2004, the Franklin Circuit Court entered an opinion and order in *Insight Kentucky Partners II, L.P. v. Revenue Cabinet*, 01-CI-01528, granting summary judgment in favor of Insight, a Kentucky limited partnership providing cable television service to customers in several Kentucky counties. Insight contended in this case, an original action for declaratory and injunctive relief, that the Equal Protection Clause of the U.S. Constitution and the uniformity provision of Section 171 of the Kentucky Constitution were violated by the assessment of cable television companies such as itself as public service corporations under KRS 136.120 while direct broadcast satellite (DBS) companies were not so assessed.



The Franklin Circuit Court agreed with Insight “that applying KRS 136.120 to cable [television] companies and not DBS companies violates [S]ection 171’s uniformity requirement.” The court stated that in order for a classification to be valid under Section 171 of the Kentucky Constitution, it must rest upon a natural, real or substantial distinction. The court stated that it did not find a substantial distinction between cable television companies and DBS companies relevant to taxation that would permit these entities to be taxed differently, consistent with Section 171.

Because its decision rested upon a state constitutional ground, the court found it unnecessary to address Insight’s Equal Protection Clause claim.

This decision is not yet final. Both parties have filed motions to alter, amend, or vacate the circuit court Feb. 5, 2004, decision.

In *Pipefitters and Joint Educational and Training Fund*, 2002-CA-002537, the Court of Appeals upheld Jefferson Circuit Court and Kentucky Board of Tax Appeals (KBTA) decisions that had affirmed the Department of Revenue’s denial of a property tax exemption to the Pipefitters Joint Educational and Training Fund (the Fund). The specific exemption the Fund claimed to be applicable was the one provided for in Ky. Const. §170 for “institutions of education not used or employed for gain by any person or corporation, and the income of which is devoted solely to the cause of education.”

The Court of Appeals’ opinion in this case reaffirms a number of principles established by this state’s highest court in its decision of *Kesselring v. Bonnycastle Club*, 299 Ky. 585, 186 S.W.2d 402 (1945). Specifically, “exemption from taxation has been strictly limited and defined. It is an exception to the rule..., for the exemption granted to one person places an additional burden upon others.” Furthermore, the granting of an exemption in the case of educational institutions is “founded upon the fundamental ground of benefit to the public by such organizations and recognition of the fact that they perform a service which the state would or should otherwise have to perform, so there is consequent tax relief of the tax

burden of others.” An organization will be exempt as an educational institution under Ky. Const. §170 if it is “a place where systematic instruction in any or all of the useful branches of learning is given by methods common to schools and institutions of learning.”

In this case, the KBTA found that the Fund’s primary purpose was the promotion of union membership and that any benefit to the public was only secondary. The Fund provided services, instruction and educational classes to individuals desiring to become pipefitters. While anyone could apply to attend the Fund’s programs, those admitted as students were required to complete an apprenticeship in a union shop with a union employer, which entailed an apprentice’s joining the union. The applicants signed an agreement as part of their entry into the Fund’s program that required them to reimburse the Fund for the costs of the training program if they did not satisfy any of the program’s requirements, which included the apprenticeship.

The KBTA further found that while the Fund taught “certain courses that are traditional in nature, such as math, computer science and telecommunications,” “these courses [were] not taught in a general way but [were] geared to the [p]ipefitters trade exclusively.” Moreover, the attendees of the Fund’s program did not receive any college credits nor were any credits obtained by the Fund’s program attendees recognized by the Commonwealth of Kentucky “as applicable to a college degree.”

The Court of Appeals concluded that “substantial evidence [in the record] supports the [KBTA’s] determination that [the Fund] is an essentially private organization with the primary intention of promoting union membership.” Accordingly, exempt status was properly denied to the Fund.

This decision, which was rendered on Jan. 27, 2004, is not yet final. The fund has filed a petition for rehearing with the Court of Appeals.

Sales and Use Tax—In *Prepaid Communications Associations, Inc. and Annox Corporation v. Revenue Cabinet*, 01-CI-01539, the Plaintiffs sought a judgment declaring that Regulation 103 KAR 28:140 “(1) subjects communications services utilized in a prepaid calling arrangement to sales and use tax in violation of KRS 139.050 (exemption for prepaid communication services); (2) is an unauthorized tax; and (3) subjects the Plaintiffs to unequal treatment.” The Franklin Circuit Court noted that the Department of Revenue has “determined that [the Plaintiff Annox Corporation] does not fall within the KRS 139.050(3)(h) exemption because it does not provide prepaid services” and “[t]hus, Annox is subject to sales and use tax pursuant to KRS Chapter 139.” The circuit court then proceeded to order the case dismissed because “[t]his action is not ripe for review because the Plaintiffs have not exhausted their administrative remedies.”

No appeal having been taken, this decision is now final.

Withholding on Net Distributive Share Income

Amendments to Regulation 103 KAR 18:070, effective Nov. 25, 2003, included a new requirement for a pass-through entity to withhold income tax at a rate of 6 percent on the net distributive share income of each nonresident individual partner, shareholder, or member. The requirement to withhold is effective for taxable years ending on or after Dec. 31, 2003.

The purpose for the regulation is to ensure that the correct amount of tax is paid to the commonwealth. Even before the regulation was promulgated, the Department of Revenue began publication efforts which included addressing this topic during the fall seminars, an article in January 2004 edition of *Kentucky Tax Alert*, and a mailing to certain partnerships. However, because the regulation was not promulgated until late in 2003, notification to all impacted taxpayers could not be performed.

Every pass-through entity is encouraged to follow the withholding requirement as promulgated for the 2003 filing period. In doing so, the following benefits will accrue:

- The pass-through entity's nonresident members will receive a benefit since they will not be required to individually file;
- The pass-through entity will become familiar with this process during the transition period;
- The pass-through entity will assist the Department of Revenue in implementing process improvements for future filing periods.

The following exceptions have been made for the 2003 transition year and withholding is not required, for:

- an entity that was dissolved during 2003; or
- an entity's nonresident members that have made estimated payments for 2003.

In addition, for the pass-through entity that is unable to immediately comply with Regulation 103 KAR 18:070, the following compliance strategy will be implemented for the 2003 transition year.

- If the tax has not been paid through either withholding by the entity or by the individual on the individual's return, compliance efforts will be directed toward only the individual during the transition year.
- Penalties for failure to withhold will not be imposed on the entity, if the entity cooperates with the department and has completed all other filing requirements timely.

The compliance process for the 2004 return will be in accordance with Regulation 103 KAR 18:070.

If you need additional information on this topic, contact Taxpayer Assistance at (502) 564-4581.

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Editors Sarah S. Gilkison
 Betty R. Sanford
 Writer Sarah S. Gilkison
 Production Alice A. Bryant
 Betty R. Sanford
 Mailing List Ladonna C. Ware

Ernie Fletcher, Governor
 Robbie Rudolph, Secretary
 Finance and Administration Cabinet

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