

Kentucky Tax Alert

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A Review of Tax Law Changes Enacted by the 2004 General Assembly

This legislative summary was compiled by the staff of the Department of Revenue's (DOR) Division of Tax Policy and is intended to present only general information concerning the major provisions of the legislation. This summary should not be construed to represent a complete analysis or specific interpretation of the law changes. Information that is more specific will be provided to taxpayers as the legislative changes are implemented. Full text of enacted bills is available on the Kentucky Legislative Research Commission home page www.lrc.state.ky.us.

The 2004 Kentucky General Assembly enacted several bills affecting Kentucky's taxpayers. The tax portion of each bill is described in this review together with other bills that have some impact on the Kentucky DOR. Unless otherwise indicated, the changes are effective July 13, 2004. For convenience, the enacted bills described in this review are grouped by tax type. When applicable, bills referencing multiple taxes are listed under each of the referenced taxes.

CENTRALIZED DEBT COLLECTION

Administrative Collection Actions—Requires each executive branch agency and the Courts of Justice to develop and maintain an accounts receivable system so that it can properly inventory all debts owed to it. Once the debts are identified, the agency and the Courts of Justice are required to commence administrative collection actions within 60 days. After the debts have become final, due and owing, i.e., all appeal remedies have either been exhausted or waived, the debts must be certified and referred to DOR to determine if it would be cost effective for the department to pursue additional collection action. **(HB 162)**

Recovery of Improper Payments—(Effective April 22, 2004) Requires the Finance and Administration Cabinet to develop an internal audit procedure for all executive branch agencies to identify *improper payments* that are defined as payments to a vendor, provider or other recipient due to error, fraud or abuse. If an executive branch agency makes an improper payment, it has 60 days after discovering the payment to recover it for the benefit of the agency. If the agency is unable to make the recovery within the allotted

time, the debt must be referred to DOR to determine the feasibility and cost effectiveness of the department collecting the debt. **(SB 228)**

Disposition of Recovered Funds—Provides that if DOR pursues collection of debts on behalf of other executive branch agencies and the Courts of Justice, the recovered funds, after deductions for the department's cost of collection, will be deposited into the General Fund unless otherwise mandated by federal law.

Participation in Refund and Vendor Offset Program—Requires the participation of each executive branch agency and the Courts of Justice in DOR's Individual Income Tax Refund Offset Program and in the Vendor Offset Program through the State Treasurer's Office. **(HB 162 and SB 228)**

SCHOOL TAX

Centralized Collection of School Tax—(Effective July 1, 2005) Transfers the administration, distribution and compliance responsibilities relating to the utility gross receipts license tax (school tax) imposed by most of the commonwealth's 176 local school districts to DOR. **(HB 163)**

TRUSTS AND ESTATES

Trusts And Estates—(Effective Jan. 1, 2005) Adopts the Kentucky Principal and Income Act by creating new sections to KRS Chapter 386; establishes definitions; establishes provisions pertaining to decedent's estate or terminating income interest; establishes apportionment at beginning and end of income interest; establishes allocation of receipts during administration of trust; establishes allocation of

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disbursements during administration of trust; and repeals the Kentucky Revised Uniform Principal and Income Act. **(HB 517)**

INDIVIDUAL and CORPORATION INCOME TAXES

Tobacco Quota Buydown Exemption—Exempts moneys that might be received from a tobacco quota buydown from the state income taxes imposed on individuals and corporations. **(HB 97)**

INDIVIDUAL INCOME TAX

Economic Revitalization Projects—The job assessment fee that may be required of employees whose jobs are preserved or created as a result of the project may not exceed 5 percent of the gross wages subject to income tax (previously, 6 percent). Employees who are assessed this fee may claim an individual income tax credit for 4/5 of the assessment (previously, 2/3). However, if an appropriation agreement is consummated, then the assessment will be 4 percent of wages (previously, 5 percent) and the individual income tax credit is equal to 100 percent of the assessment (previously, 4/5). Also, if the project is located in an area where the local government or governments assess an occupational license fee of less than 1 percent, then the assessment fee and individual income tax credit will equal 4 percent of wages plus the amount of occupational license fee that local government agreed to forgo. The assessment fee and individual income tax credit is 4 percent of wages if the project is located in an area where the local government or governments do not impose an occupational license fee. Further, employees that are assessed this fee are also entitled to a credit against any local occupational license fee equal to 1/5 of the assessment (previously, 1/6) or equal to the amount of the local occupational license fee if the appropriation agreement is consummated.

If the authority has entered into a preliminary agreement with a taxpayer prior to 90 days after the adjournment of the 2004 legislative session, then the taxpayer has a one-time option to choose whether to operate under the new or old provisions. Also, if a taxpayer has entered into a final agreement, then the taxpayer may choose whether to operate the job assessment fee under the new or old provisions.

(HB 593 and SB 248)

CORPORATION TAXES

Bank Holding Companies—(Effective for tax returns due without regard to extension on or after April 15, 2004) Retroactively reinstates the deduction option provided by KRS 136.071 that was eliminated by the *Illinois Tool Works* decision. A bank holding company as defined in KRS 287.900 may deduct from its taxable capital, the book value of its investment in the stock or securities of subsidiaries that are subject to the bank franchise tax. A bank holding company must own more than 50 percent of the outstanding stock of a bank subsidiary in order to claim the deduction for that subsidiary. This legislation does not permit the filing of a

consolidated corporation license tax return. More detail on this issue can be found at DOR's Web site at revenue.ky.gov/pdf/hb292.pdf. **(HB 292)**

Corporation License Tax Returns for Corporations other than Bank Holding Companies—No legislation was passed by the 2004 General Assembly concerning the reinstatement for corporations other than bank holding companies of the corporation license tax benefits formerly offered by KRS 136.071. The 2003 General Assembly had enacted HB 390 to effect a partial reinstatement (90 percent) of these benefits for qualifying corporations for tax returns due without regard extension on or after April 15, 2004, but before April 15, 2005.

Former Governor Patton vetoed these corporation license tax provisions of HB 390, however, and this veto is being challenged in the case of *Citizens National Corporation v. Rudolph*, 03-CI-00917, now pending before the Franklin Circuit Court.

In light of the extraordinary legal uncertainty presented by this sequence of events, corporations other than bank holding companies, which are governed by HB 292, will be permitted by DOR the vetoed provisions of HB 390 for the time being, until a final and unappealable decision is rendered in *Citizens National Corporation v. Rudolph*. If the veto is upheld by the courts in *Citizens National* and if no legislation to the contrary is enacted, the taxpayers affected will be required to pay additional amounts of corporation license tax representing the full amount of corporation license tax that would have been due had HB 390 not been enacted. However, those taxpayers will not be required to remit penalties or interest on those additional amounts if they have complied with the provisions of HB 390. Details on how to calculate license tax under the provisions of HB 390 may be found at DOR's Web site at revenue.ky.gov/pdf/hb390.pdf.

Economic Development Incentives—Increases the amount of tax credit available under the Kentucky Industrial Revitalization Act (KIRA) to 75 percent of approved costs. The KIRA corporation license tax credit language of KRS 136.0704 was changed to allow the credit to be for the license tax attributable to the entire location of the project. This bill also tightens up the state's authority to terminate economic development projects that do not meet the targeted employment amounts. **(HB 593)**

Rural Economic Development Incentives—Exempts nonprofit corporations that employ handicapped and sheltered workshop employees at federally established subminimal wages from minimum wage requirements established for companies that seek rural economic development incentives. **(SB 231)**

Economic Revitalization Projects—Increases the amount of tax credit available under KIRA to 75 percent of approved costs. KIRA corporation license tax credit language of KRS 136.0704 was changed to allow the credit to be for the license tax attributable to the entire location of the project. These provisions were also enacted by HB 593. **(SB 248)**

Kentucky Investment Fund Act—(Effective after July 1, 2004) An investment fund approved by the Kentucky Economic Development Finance Authority (KEDFA) that qualifies for tax credits pursuant to the Kentucky Investment Fund Act may invest up to 100 percent of its committed cash contributions in a single knowledge-based entity. A city, county, other local government entity or any entity approved by KEDFA may invest in an investment fund created for the purpose of investing in a single knowledge-based entity and may transfer the approved tax credits to a private entity.

(HB 292)

TOBACCO

Escrow Payments by Nonparticipating Manufacturers—Allows the attorney general to promulgate administrative regulations requiring nonparticipating manufacturers to make quarterly escrow payments and to produce information sufficient to enable the attorney general to determine the adequacy of the escrow payments. Also requires nonparticipating manufacturers to base their escrow payments on the number of cigarette units sold in the state.

(HB 97)

HAZARDOUS WASTE ASSESSMENT FEE

Extension of Hazardous Waste Assessment Fee—Extends collection of the hazardous waste assessment fee until June 30, 2006, rather than June 30, 2004. *(SB 222)*

Extension of Underground Storage Tanks Program—Extends the small operators assistance program and the time tank owners can file for assistance to Jan. 15, 2008, requires tanks installed after July 15, 2004, to be registered in order to participate in the fund as well as requiring that all currently existing tanks be registered by July 15, 2006, and allows reimbursements for corrective action to be submitted through July 15, 2013. Additionally, it deletes July 15, 2010, as the deadline for submission of petroleum storage account claims. *(SB 224)*

EXCISE TAX

Reimbursement of Manufacturer's Excise Tax—Reimbursement to a manufacturer for the excise taxes as found in Subchapter A of the Internal Revenue Code will not be required more than one business day before the tax has to be remitted by that manufacturer. Subchapter A deals in part with petroleum products. *(HB 297)*

PARI-MUTUEL TAX

Harness Track Exemption—Exempts harness tracks from paying the pari-mutuel excise tax imposed by KRS 138.510(2) and the amount that would have been paid by the track shall be kept to promote and maintain its live meet. *(HB 708)*

Wagering Hub—Allows for the establishment of an international wagering hub and further provides that such an entity would be exempt from the race track admissions tax, the pari-mutuel tax, and the license tax on race meetings.

(HB 708)

PROPERTY TAX

Calculation of Taxable Capital—Allows a revised method of calculating taxable capital for some Agricultural Credit Associations. *(HB 292)*

Taxation on Abandoned Urban Property—Allows any city of the second to sixth class to levy a separate rate of taxation on abandoned urban property and provide a list of abandoned properties to the county property valuation administrator. *(HB 373)*

Tax Levy by Fire District—Allows a fire protection district or a volunteer fire department district that operates an emergency ambulance service and is the primary service provider in the district to levy a tax upon the property in the district of up to 20 cents per \$100 of value. *(HB 406)*

Delinquent Property Taxes—Certificates of delinquency in metro Louisville are exempt from the requirements for advertising and sheriff's sale; inclusion of additional costs, including attorneys fees, allowed in liens placed upon delinquent property; expansion of the list of costs subject to the calculation of the 12 percent interest to include advertising costs, a \$5 sheriff's fee, the county clerk's fee and the county attorney's fee, allowed for metro Louisville and any other county that passes an enabling ordinance. *(HB 510)*

Notice of Expiration of Tax Items in Budget

The following tax provisions appeared in HB 269, the budget bill for Fiscal Years 2002-2004. These provisions, therefore, will expire with the current budget on June 30, 2004:

- the provision that limited the cap on vendor compensation for sales tax to \$1,500 will expire;
- the provision imposing sales tax on natural gas transmission and distribution charges will expire;
- the cigarette compensation to wholesalers will return from 15 cents to 30 cents face value for each \$3 of cigarette tax evidence.

For financial planning purposes, please be advised that these provisions, which will expire June 30, did appear in both the House and Senate versions of the proposed budget bills this last session. There remains, therefore, the possibility that the General Assembly could reenact these provisions retroactively in the budget when it is passed.

Court Case Updates

Corporation Income Tax—In *Asworth Corporation v. Revenue Cabinet*, 03-CI-00856, the Franklin Circuit Court denied the taxpayers' petition for a writ of mandamus directing DOR to produce "(i) records of non-party taxpayers and (ii) preliminary recommendations, drafts, proposals and analysis of proposed amendments to legislation that was never enacted." The Kentucky Board of Tax Appeals (KBTA) had denied the taxpayers' efforts to secure the production of this information via discovery.

In its March 16, 2004, order denying the petition for a writ of mandamus, the circuit court ruled that a writ of mandamus was not warranted because the taxpayers had an adequate remedy on appeal from the KBTA's decision. Furthermore, the court held that the KBTA did not abuse its discretion in denying the discovery sought by the taxpayers. The information demanded by the taxpayers was "neither relevant nor reasonably calculated to lead to the discovery of admissible evidence."

The taxpayers' motion to alter, amend or vacate the circuit court's March 16, 2004, order was denied by an opinion and order entered on April 22, 2004.

No appeal having been taken, the circuit court's decision is now final.

Sales and Use Tax— At issue in *GTE South, Inc. v. Revenue Cabinet*, 2003-CA-00773 was the application of KRS 139.620(1), which states:

As soon as practicable after each return is received, the cabinet shall examine and audit it. If the amount of tax computed by the cabinet is greater than the amount returned by the taxpayer, the excess shall be assessed by the cabinet within four (4) years from the date the return was filed, except as provided in subsection (2), and except that in the case of a failure to file a return or of a fraudulent return the excess may be assessed at any time. A notice of such assessment shall be mailed to the taxpayer. The time herein provided may be extended by agreement between the taxpayer and the cabinet.

The Revenue Cabinet issued the taxpayer an assessment in the amount of \$370,313.33 for the period of Feb. 1, 1991, through Sept. 30, 1993. Under KRS 139.620(1), the Cabinet had until Oct. 20, 1997, to assess any sales and use taxes against the taxpayer for this period.

Sometime in Oct. 1997 the Cabinet mailed the taxpayer an *assessment letter* dated Oct. 16, 1997, which set forth the basis and amount of the assessment. This letter included a narrative report along with supporting schedules. It stated that formal notices of tax due, including the interest and penalties assessed against the taxpayer, would be mailed separately. On Oct. 24, 1997, the taxpayer received the notices of tax due in an envelope postmarked Oct. 21, 1997.

The taxpayer protested the assessment, contending that the assessment was untimely under KRS 139.620(1) and therefore void, because the notices of tax due had not been mailed on or before the Oct. 20, 1997, deadline. The KBTA agreed with the taxpayer, but the Franklin Circuit Court reversed and reinstated the assessment. The circuit court ruled that the assessment letter constituted sufficient notice under KRS 139.620(1) and that this notice was timely mailed.

In an opinion rendered on April 2, 2004, the Court of Appeals reversed the circuit court's decision. The Court did reject the taxpayer's contention that the assessment letter was not mailed on or before the Oct. 20, 1997 deadline. The burden rested upon the taxpayer to establish the facts necessary to support its statute of limitations defense based upon KRS 139.620(1). A witness for the taxpayer testified that he was at first unsure when he had received the assessment letter, but later found a post-it note in his own handwriting indicating that he had received it on Oct. 27, 1997. However, this witness did not open the envelope containing the assessment letter himself nor had that envelope been retained by the taxpayer. The taxpayer's witness further acknowledged that it was not unusual for his secretary or supervisor to open his mail before it reached his desk.

The Court of Appeals held that this proof did not rise to the level of substantial evidence needed to support the KBTA's finding that the assessment letter was mailed beyond the Oct. 20, 1997, deadline. This ruling did not save the assessment from being untimely under KRS 139.620(1), however. The Court of Appeals ruled that proper notice of the assessment must be mailed within the four-year period prescribed by KRS 139.620(1) or in this case, on or before Oct. 20, 1997, **and** that this notice must comply with KRS 131.081(8), which states:

The cabinet shall include with each notice of tax due a clear and concise description of the basis and amount of any tax, penalty, and interest assessed against the taxpayer, and copies of the agent's audit workpapers and the agent's written narrative setting forth the grounds upon which the assessment is made.

The Court of Appeals agreed with the taxpayer that the assessment letter was deficient under KRS 131.081(8) because it did not contain information concerning the amount of the interest or penalties assessed against it by the Cabinet. This information was included in the notices of tax due, which were admittedly mailed beyond the Oct. 20, 1997 deadline. Because all of the elements specified in KRS 131.081(8) had not been included in a notice mailed **before** Oct. 20, 1997, the Court of Appeals held that the Cabinet had not strictly complied with KRS 139.620(1) and accordingly, the assessment could not stand.

The Court of Appeals also ruled that the taxpayer was not necessarily entitled to a refund it had claimed for the period for which tax had been assessed. Under KRS 134.580 and 139.770, a taxpayer is entitled to a refund only if it can establish that it has in fact overpaid its taxes for the period in question. Relying upon "principles enunciated by the [United States] Supreme Court in [*Lewis v. Reynolds*, 284 U.S. 281 (1932), *modified*, 284 U.S. 599 (1932) that] have become ingrained in the jurisprudence of tax law," the Court of Appeals held that the fact of the underpayment represented by the time-barred assessment could nevertheless be used by the Cabinet to establish that there had been no overpayment of tax for the period in question and thus no entitlement to a refund.

On June 7, 2004, the Court of Appeals denied DOR's petition for rehearing.

The Court of Appeals' decision in this case is not yet final. The parties have 30 days from the Court's June 7, 2004, ruling on DOR's petition for rehearing in which to file motions for discretionary review with the Kentucky Supreme Court.

