Kentucky Society
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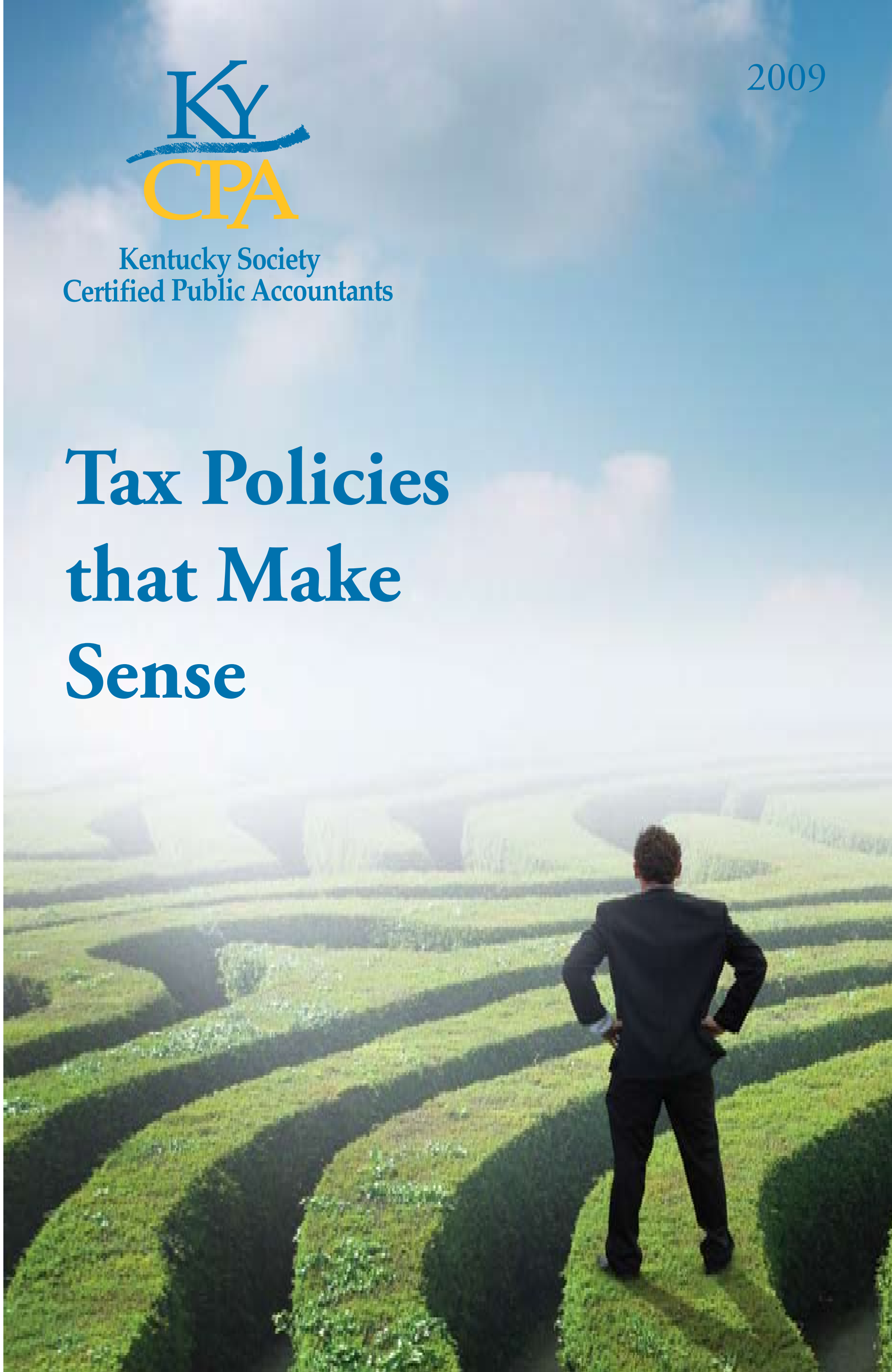
Tax Policies that Make Sense



KyCPA Tax Committee members are available to respond to questions and offer advice within their areas of special expertise. Please contact Penny Gold, CEO, at 502.266.5272 or pgold@kycpa.org.

Kentucky's tax statutes and the policies they embody are not only important but consequential: both corporate and individual taxpayers will choose to act in some ways and not others, to invest in some activities and not others, and even to move into or out of this state – all based to some extent on state taxes. Because tax laws are adopted and amended over time, their "organic" growth can sometimes result in complex, unfair, or contradictory results.

Policymakers considering future changes in Kentucky's tax laws have a unique opportunity to make our tax policies simpler, clearer, fairer, more competitive, more coherent, and easier to obey. We hope that the guiding principles we have addressed in this brochure prompt discussion toward that goal, and we look forward to participating in a continuing dialog to achieve it.

To print out additional copies you may download this booklet at www.kycpa.org/docs/taxpolicy.pdf.

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The Kentucky Society of Certified Public Accountants (KyCPA) promotes adherence to high professional and ethical standards. We represent the interests of the accounting profession and promote awareness of our responsibility to the public interest.

KyCPA enjoys a broad membership of 5,000, including about 75% of all CPAs practicing in Kentucky.

As CFOs, controllers, and trusted business advisors, our members coordinate taxpayer situations with the Commonwealth's tax rules. We represent taxpayers who need help complying with Kentucky's tax laws.

Overview

Many state tax provisions are complex, and their full effects are not always readily apparent. KyCPA members are uniquely qualified to help analyze tax policy alternatives and to articulate their likely effects. KyCPA stands ready to use its unique expertise and experience to advise legislators, administrators, industry groups, and taxpayers.

Legislators may be revising Kentucky's tax laws in the near future. As the state prepares both for a possible 2009 special legislative session to address the budget shortfall in the 2009–2010 fiscal year and for the 2010 General Assembly, policymakers should strive to make changes that improve Kentucky's tax system.

This brochure represents the best thinking of KyCPA's Tax Committee on Kentucky tax policy, both generally and specifically. We offer it to public policymakers constructively, hoping that its principles and analysis will not only be considered, but also embedded in any future changes in Kentucky's tax laws and regulations.

KyCPA members are professionals who spend a lot of time and energy interpreting and applying tax statutes and regulations in the real world. We know what a clear, coherent tax policy would look like – and, frankly, Kentucky's tax policy is not nearly as clear and coherent as it could be.

Kentucky's tax policy should:

- **Be certain**
- **Be equitable, fair, and neutral**
- **Be simple and collectible**
- **Promote economic growth**
- **Be transparent and clear**
- **Be predictable**
- **Be consistent**
- **Be supported by clear administrative guidance**
- **Integrate with other state and federal procedures**
- **Avoid double taxation and pyramiding**

6. Administrative guidance

In the last few years, the legislature has changed Kentucky's tax laws several times, but not every change was an improvement. The 2005 Kentucky Tax Modernization initiative departed significantly from Kentucky's historical approach to business taxation. Most of the 2005 changes' unintended consequences were resolved with changes that took effect in 2007.

Before the 2005 Tax Modernization, the Department of Revenue had a long history of publishing helpful guidance in interpreting Kentucky's complicated tax laws. Guidance was in the form of instructions to tax forms and, importantly, the publication of the Department's internal Policies and industry-specific Circulars.

While some of the many Policies and Circulars needed only revision, the Department instead revoked almost all of them, leaving taxpayers, advisors, software vendors, and administrators with little reliable official guidance. The Department of Revenue reissued most of its administrative regulations – but without the old regulations' helpful examples. The regulations now mostly restate the statutes they are supposed to interpret.

The Department of Revenue has recently increased its audit efforts, including the use of criminal sanctions against taxpayers found to violate Kentucky tax statutes.

Taxpayers and their advisors urgently need clear, reliable tax guidance. As a matter of simple fairness, we urge the Department to resume publishing its internal policies and other helpful guidance. This may require permissive changes to Kentucky's statutes, but it may simply need administrative action.

We support a system that is equitable, certain, transparent, efficient, easy to collect, neutral among taxpayers, and conducive to economic growth and efficiency. Action by Kentucky to increase estate tax revenue through decoupling from the federal estate tax regime, or by imposing tax with reference to no longer effective federal estate tax law, would violate these guiding principles because:

- Such changes would **add to the uncertainty** already experienced by taxpayers due to the shifting status of the federal estate tax.
- Increasing the tax burden on estates would **encourage more residents to move** to a jurisdiction that either has no estate tax or that has remained coupled to the federal estate tax system. Aside from the loss of estate tax revenue, before the death of the former Kentuckian, the move to another state results in a loss of income, sales, use, gasoline, alcohol, tobacco, property, and other taxes!

When someone leaves Kentucky to avoid an unfair estate tax burden after death, the Commonwealth also loses all income, sales, use, gasoline, alcohol, tobacco, property, and other taxes that person would have paid while living.

- The **collection process would be inefficient** because the state could not rely on the federal audit process. This is because many estates would not be required to file federal estate tax returns because only large estates are subject to the federal estate tax.

Because the federal estate tax system may be changed by upcoming federal legislation, Kentucky should delay any action in this area until the results of the federal changes are known and digested.

Increasing Kentucky's estate tax revenue by decoupling it from the federal estate tax regime would violate our guiding principles.

Based on a practical understanding of federal and state tax policy, members of the KyCPA Tax Committee have applied these guiding principles to specific areas of tax law in this brochure. In addition, committee members are available to discuss this analysis in detail. To reach a KyCPA Tax Committee member, contact Penny Gold at 502.266.5272 or pgold@kycpa.org.

Our goals are simple: to improve Kentucky's financial situation and to help build a foundation of tax clarity, consistency, and easy compliance for Kentucky's taxpayers and tax administrators.

KyCPA members are eager to advise legislators, administrators, industry groups, and taxpayers on Kentucky tax policy – particularly before tax legislation or regulations are proposed or finalized.

To reach a KyCPA Tax Committee member, contact Penny Gold at 502.266.5272 or pgold@kycpa.org.

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Taxes' effect on behavior

Tax policymakers should keep in mind the power of tax policy in affecting behavior. Kentucky offers economic and tax incentives to encourage businesses to locate here. In addition, deductions or tax credits for education expenses and employee training are attempts to affect behavior. Taxes can be an important component of major financial decisions, including where a business locates or expands, or where a person retires.

Even a small tax benefit can motivate behavior. For example, the differential in sales tax rates between Kentucky and a bordering state can determine where a person shops. Not only will a Kentucky retailer lose business to a retailer in another state, but a $10 sales tax savings for the shopper results in $60 less revenue for the Commonwealth. The difference is exaggerated when shoppers cross borders for high-ticket items.

- **Recognize that imposing sales tax on services is a BIG step.** Applying the sales tax to previously untaxed services could adversely affect Kentucky businesses and inhibit economic development. The issue is that many services can be acquired from vendors located in other states.

  A lawn care company providing services to a Kentucky customer, must provide those services here. But other services are quite portable: a Kentucky business or individual can easily acquire consulting, advertising, engineering, architectural, accounting, legal, medical, computer repair, and many other services from providers outside Kentucky. Imposing sales tax on such services could have a dramatic adverse impact on the ability of Kentucky businesses to attract customers.

- **Grant exemptions sparingly.** Kentucky's sales tax law is riddled with exemptions. Some, such as those for food, meet logical social goals. But others give the impression of political favoritism and impugn the integrity of Kentucky's tax system. Taxpayers' enthusiasm for paying taxes is directly related to how fair they perceive the system to be.

5. Estate tax policies

Before 2002, Kentucky's estate tax was triggered by the state death tax credit taken on the federal estate tax return. Because the estate received a credit on the federal return, the executor was actually eager to pay the Kentucky tax since the Kentucky receipt was necessary to support the federal credit.

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 phased out the state death tax credit between 2002 and 2004. Since 2005, the state death tax credit has been replaced by a deduction for state death taxes paid.

As a direct result of the federal changes in the state death tax credit, Kentucky lost substantial estate and inheritance tax revenue. Recently, there have been proposals to reinstitute the Kentucky Inheritance and Estate tax based on 2001 federal estate tax thresholds and methodology.

4. Sales and use tax policies

In recent years, Kentucky's tax system has been updated, modified, and modernized – but not always improved. We urge policymakers to consider the following five guidelines when considering any further changes to Kentucky's sales and use taxes:

- **Adopt definitions consistent with those of other states.** Clear statutory definitions enhance a taxpayer's ability to comply, enable the Department of Revenue to enforce Kentucky's statutes effectively, and reduce the number of expensive controversies about tax computations. Kentucky should adopt definitions proposed by the Streamlined Sales and Use Tax initiative (see www.streamlinedsalestax.org).

  Conforming Kentucky's definitions to those of other states does not require that its tax laws be the same as the other states. Kentucky can still exempt transactions that other states tax – but tax compliance is enhanced if states use identical definitions. This is the reason for the Streamlined Sales and Use Tax initiative.
- **Avoid tax "pyramiding."** Sales and use taxes should be imposed at only one level. For example, Kentucky law appropriately exempts inventory purchased for resale, imposing sales tax only when the ultimate consumer buys an item at retail.
- **Recognize that sales and use taxes have economic development implications.** Some exemptions from sales and use tax exist to keep Kentucky businesses competitive with retailers in nearby states. This is especially important because businesses in many large Kentucky communities compete with businesses just across the state line.

  In these situations, a border state's lower sales taxes exert a powerful pull for Kentuckians to shop there. Conversely, lower sales taxes in Kentucky tend to attract shoppers to Kentucky – for example, Indiana's 7% sales tax makes Kentucky a relatively attractive shopping venue. (Obviously, these principles have implications in the taxation of tobacco and alcohol products.)

1. Guiding principles for state taxation

The power to tax is the power to control public and private behavior. It is one of the essential powers of federal, state, and local governments. When tax statutes and regulations embody sound, clear tax policy, everyone benefits: corporate and individual taxpayers can predict the tax consequences of their actions, administrators can produce clear rules and collect taxes easily, and governmental units can get the revenue they need.

Conversely, when tax policies are complex, vague, contradictory, or unpredictable, everyone loses: taxpayers get confused and don't pay the taxes they owe, administrators can't produce clear regulations or collect taxes easily, and governments struggle because they don't get the tax revenue they expect.

KyCPA recommends that Kentucky tax policy be based on these 10 principles:

- **Certainty:** Continual change and lags in administrative guidance heighten taxpayer uncertainty. Reducing the frequency of rule changes and using consistent concepts and definitions is an important element of a sound and enforceable tax policy. Changes should take effect only prospectively, not retroactively.
- **Equity, fairness, and neutrality:** Not only must state tax law be fair, but the public must perceive it as being fair. Narrow or targeted exemptions from sales, use, or any other state tax create perceptions of favoritism and unfairness. Kentucky should avoid taxes that apply only to a small group of taxpayers or are unevenly enforced. Social equity demands that similarly situated taxpayers should pay the same taxes.
- **Simplification and economy of collection:** Simplification should be a high priority. It will minimize the costs of the Department of Revenue, including the administrative costs associated with collecting taxes, examining returns, and resolving disputes.

> **Tax complexity itself is a kind of tax.**
> **~ Max Baucus**

- **Economic growth:** Tax policy should not divert government or business resources from productive activities into excessive and non-productive compliance costs. Kentucky tax policy should be formulated to make the state a welcoming place to do business for existing as well as new businesses. The state should continue to recognize that sales and use, income, and other taxes have economic development implications, and many existing Kentucky businesses often compete with businesses across state lines.

  Coherent tax policy encourages economic development, creating jobs and enhancing Kentuckians' well-being.
- **Transparency and clarity:** It is self-evident that taxpayers, their advisors and tax administrators should be able to understand how the tax law applies. Kentucky would benefit by minimizing compliance burdens, which would in turn narrow the tax gap (the difference between taxes owed and taxes paid voluntarily).
- **Predictability:** Kentucky should enact tax laws only prospectively to give the Department of Revenue, practitioners, software vendors, businesses, and individuals enough time to prepare for changes. Retroactive tax laws should not be enacted – and tax laws should provide for clear, bright-line rules whenever possible.
- **Consistency:** The Commonwealth should generally retain the structure of any given tax from one year to the next, absent compelling reasons for change. Another wholesale rewrite of Kentucky's income tax laws would be premature. The General Assembly accomplished a substantial rewrite of Kentucky's income tax statutes in 2005 and 2006 – less than three years ago. Groups such as the Multistate Tax Commission and the National Conference of Commissioners on Uniform Laws are studying a revised Uniform Division of Income for Tax Purposes Act, so Kentucky should wait on wholesale changes to the corporation income tax.
- **Clear administrative guidance:** Given the dynamics of tax laws and everyone's interest in full compliance, taxpayers (and their advisors, such as CPAs) need clear and reliable guidance. Before Tax Modernization a few years ago, the Kentucky Department of Revenue had a long history of publishing helpful guidance that

3. Individual income tax policies

We support a system that mirrors the federal income tax system as closely as possible. While the federal tax system is far from meeting our Guiding Principles, it is the one that individuals and businesses must understand and apply to their financial matters, regardless of Kentucky tax law. By having a tax system that closely mirrors the federal system, Kentucky would minimize the incremental burden of compliance with its system. Specifically, we note three ways the current "unmirrored" system burdens individual taxpayers:

- **SMLLCs:** Kentucky taxes single-member limited liability companies (SMLLCs) differently depending upon ownership: Individual SMLLC owners must file and pay the LLET, but SMLLCs owned by corporations file no returns and pay no separate tax.
- **Former Kentuckians:** Some former Kentuckians now residing outside the United States may still be subject to Kentucky income taxes though they would not be subject to Kentucky tax if they resided in another state. To make matters worse, they are not allowed a credit against their Kentucky income taxes for comparable taxes paid in a foreign country, so they are taxed twice on the same income.
- **Federal/state exemption differences:** Some types of income are exempt from federal income taxes but are taxable for Kentucky income tax purposes. There are also computational or qualification differences between deductions and credits for federal and Kentucky tax purposes.

Taxpayers' enthusiasm for paying taxes is directly related to how fair they perceive the system to be.

On the negative side, these factors can impair economic development:

- High statutory tax rates
- Constantly changing tax rates, apportionment factors, tax base computation, or tax structure
- Difficulty in complying with tax laws due to needless complexity or vagueness in regulatory and administrative guidance
- Incompatibility with tax methodology and compliance procedures used at the federal level and by other states
- Multiple tax jurisdictions with additional taxes and different compliance rules (Kentucky imposes income tax on personal and business income, as do multiple local occupational tax jurisdictions)
- Kentucky's "nexus" rules are complicated and hard to apply. Kentucky can tax only business activities occurring in Kentucky – that is, those with a connection, or nexus, with the state. It would be appropriate to examine Kentucky's nexus rules to ensure that they are constitutional, proportionate, productive, and do not result in double taxation.

On the positive side, Kentucky's tax rules can also be an incentive for businesses to locate or expand here:

- As an economic development tool, many states have changed their corporate apportionment formula from three factors (sales, property, and payroll) to one – sales. If adopted in Kentucky, such a formula would shift the corporate tax burden from businesses located in Kentucky, but whose customers are outside Kentucky, to non-Kentucky businesses that sell products and services in Kentucky. The result is a shift in corporate income tax burden encouraging Kentucky-based businesses, and increasing Kentucky jobs, and boosting Kentucky payroll, income, property, and sales taxes.
- Kentucky's system of tax incentives should be monitored to ensure that it yields the intended results and that existing Kentucky companies are not disadvantaged.

assisted taxpayers and auditors in interpreting Kentucky's sometimes-complicated tax laws. Guidance appeared in the form of instructions for tax forms and, importantly, in the Department's published Policies and industry-specific Circulars.

While many Policies and Circulars needed revision, the Department revoked the majority of them, leaving taxpayers, advisors, and administrators without reliable guidance. Then the Department reissued most of its administrative regulations – minus the helpful examples found in the old regulations. In many cases, the new regulations simply restate statutes.

Another wholesale rewrite of Kentucky's income tax laws would be premature.

We urge the Department of Revenue to resume publishing its internal policies, continuing education materials, examples, and other helpful pronouncements. This may require permissive statutory amendments or may simply require administrative action. Ultimately, this will minimize the cost of tax administration and improve the state's cash flow by minimizing errors and unnecessary disputes.

- **Uniform with other jurisdictions and federal procedures:** Kentucky should strive to adopt uniform laws and compliance procedures that conform to federal procedures and those of other states. Specifically, we note three areas that add excessive incremental burdens to Kentucky's current system:
  - Significant **lags in adapting to the federal Internal Revenue Code** (IRC) as it changes are causing significant interpretative, administrative, and compliance problems. Currently, Kentucky tax statutes are based upon the IRC as it existed back on Dec. 31, 2006.
  - Kentucky's **not conforming with IRC Section 179** (the election to expense some equipment) creates problematic differences between federal and Kentucky depreciation calculations. These and other depreciation differences cause businesses to make separate – and sometimes massively different – depreciation calculations for federal and Kentucky income tax purposes.
  - Kentucky's **consolidated return nexus rules** are unclear and idiosyncratic. Clarifying and conforming these rules to those of other states would ease compliance and keep multiple states from taxing the same income.

- **Avoid double taxation and pyramiding of taxes:** Kentucky should enact and retain tax laws that apply only one level of tax to a transaction or taxpayer. (For example, Kentucky law appropriately exempts inventory purchased for resale. Sales tax is imposed only when the ultimate consumer buys the inventory.)

2. Corporate income tax policies

In recent years, the General Assembly changed Kentucky's corporate income tax system materially. We continue to hear considerable discussion about future comprehensive changes to how Kentucky taxes business entities operating here.

Policymakers considering changes in Kentucky's corporate tax law should:

- Carefully evaluate the effect of adopting a **single sales factor** for apportioning a multistate entity's income (KRS 141.120). Changing the apportionment formula involves a significant shift in tax burden, even if the overall effect is revenue-neutral.
- Consider changing the **related-party add-back provisions** to grant more exceptions, such as those other states grant to ensure that taxpayers are not subject to double taxation and are not kept from taking deductions simply because of lack of compliance with vague tax return disclosure rules (KRS 141.205)
- Clarify the **consolidated return nexus rules** (KRS 141.200)
- Repeal **retroactive or pyramiding taxes**
- Consider repealing the **limited liability entity (LLET) gross receipts tax** on businesses experiencing a net loss
- Consider the benefits of adopting **uniform laws,** such as the current Uniform Division of Income for Tax Purposes Act, or at least amend existing tax laws to be consistent with our Guiding Principles described above

Any changes in Kentucky law must take into account the differences in methodology for the taxation of corporation income vs. family/entrepreneurial business income.

Some industries should be taxed differently

Tax policy should address industries' different operations and structures. **Changes in Kentucky tax policy should consider the special circumstances of industries such as:**

- Banks
- Savings & loans
- Credit unions
- Insurance companies
- Investment companies
- Venture capital partnerships
- Mutual funds
- Cooperatives
- Tax-exempt organizations
- Public service corporations
- Real estate investment trusts

Gross receipts taxes are sometimes punitive

Imposing an income tax when a business has a net loss is inherently unfair. This is the case with the limited liability entity tax (LLET). High-volume, low-margin taxpayers are especially vulnerable to paying LLET that greatly exceeds the income tax burden of other similarly profitable businesses. The alternative calculation based on gross profit has done little to lessen this unfair burden.

Kentucky's income tax policies affect economic development

Businesses can choose which state they invest in, so Kentucky's tax policy can influence Kentucky's economic development efforts directly.

	Corporations	Pass-through Entities (PTEs)
Tax paid by	Corporation	Individual owners
Amount taxed by Kentucky	% of activity in Kentucky computed using three-part Apportionment formula	100% of all income included in owners' Kentucky income tax returns
Amount taxed by other states	% of activity in state computed using state-mandated Apportionment formula	% of activity in state computed using Apportionment formula
Double taxation avoided by	Use of apportionment formula	Credit against Kentucky taxes for taxes paid to other states
Important Kentucky tax policy issue	Apportionment formula that encourages growth of Kentucky businesses	Taxes paid must qualify for credit on owner's resident state return to avoid double taxation. This is an issue both for Kentucky residents and for residents of other states.

Disparate treatment of corporate income vs. family/entrepreneurial business income

Large (and medium–sized) corporations and family (or entrepreneurial) businesses tend to be taxed quite differently:

- **Large and medium-sized corporations:** Most large and medium-sized corporations pay Kentucky income tax on their corporate net income. Corporate stockholders pay income tax on corporate profits when they receive dividends.

  The portion of a corporation's adjusted federal income that Kentucky imposes income tax on is determined using an ***apportionment formula.*** Like many states, Kentucky's formula uses three factors: Kentucky sales, property, and payroll as a percent of total sales; property; and payroll. But because apportionment formulas and nexus rules vary by state, the sum of the apportionment percentage for each state can add up to more or less than 100%. Larger variations between state apportionment rules can occur for service-based businesses.

  Wise corporate tax planning strives to configure business operations and legal entities so that: (a) apportionment percentages total less than 100%; and (b) a greater proportion of corporate income is assigned to states with lower income tax rates or no income tax.

- **Family or entrepreneurial businesses:** Most family or entrepreneurial businesses, including some substantial ones, are set up and operate as pass-through entities (PTEs). These include proprietorships, partnerships, limited liability companies, and S corporations.

  Unlike corporate taxpayers, PTE owners must include their businesses' net income on their personal income tax returns. Stockholders, members, partners, or owners include their share of business income on their individual federal income tax returns. This entire amount of PTE income in turn is included in the state income tax return for the state where they reside. In addition, the states where the business operates may impose an income tax on the activities that occur in its state.

Most family and entrepreneurial businesses are pass-through entities (PTEs).

To avoid double taxation on the business income, an individual owner reduces Kentucky income tax by the ***credit for taxes paid to other states.*** The credit is limited to the Kentucky tax on that income. For example, a Kentucky resident gets full credit for Indiana's 3.4% income tax (the credit for Indiana tax reduces Kentucky's 6% tax to 2.6% on Indiana income), a tax imposed at 7% results in a Kentucky credit of only 6%. Thus, in effect, Kentucky family business owners ***never*** pay state income tax on less than 100% of business income – but they sometimes pay more!

Any changes in Kentucky law must take into account the differences in methodology for the taxation of corporation income vs. family/entrepreneurial business income.

Taxation of non-resident owners of family businesses

As noted, Kentucky residents include income from non-Kentucky sources on their Kentucky income tax returns and receive a credit for taxes paid to other states. The same is true in reverse for non-residents; they include Kentucky business income in their personal taxable income and receive a credit on their individual returns for income taxes that they pay Kentucky. To avoid unfairly penalizing non-resident owners of Kentucky businesses, it is important that Kentucky's tax imposed on the income of PTEs easily qualify for credit on the non-Kentucky income tax returns of non-resident owners of Kentucky businesses.

This was a big problem under 2005 and 2006 Tax Modernization for Ohio residents with Kentucky business interests, because Ohio law does not allow an Ohio resident to get credit for taxes owed by the business entity; only income taxes paid by or on behalf of the individual to Kentucky qualify for Ohio's individual tax credit. (Kentucky has the same rule as it relates to entity-level taxes paid in Tennessee.) So Ohio resident

owners of Kentucky businesses experienced double taxation on Kentucky income in 2005 and 2006 – once to Kentucky at the entity level and once to Ohio at the personal level. This could have been avoided for 2005 and 2006 if the tax had been (a) a mandatory withholding or composite filing for all owners of PTEs or (b) imposed on the PTE owner's net distributive income rather than on the business entity itself. The problem described above was partially resolved for 2007 and future years, but still exists to the extent that the business owes the Limited Liability Entity Tax (LLET).

Coordinating Kentucky tax law with the laws of other states is important because:

- Any taxpayer detriment caused by Kentucky's tax structure will occur in the calculation of the amount of tax paid to other states or the credit received in other states. Non-residents pay higher taxes to their home states as a result of Kentucky's tax structure, but Kentucky's tax revenue is not enhanced by even $1.
- Generally, PTE owners are more sensitive to tax increases than shareholders of C corporations because the money comes out of their personal bank accounts.
- Non-resident owners should not be discouraged from increasing their investment in Kentucky businesses that produce jobs for Kentuckians and tax revenue for the state.
- We should not give non-resident business owners any reason to consider moving their Kentucky business operations out of Kentucky. Instead, we should create a tax climate in Kentucky that is more attractive than all of its neighboring states.