Kentucky Tax Alert

A KRC PUBLICATION FOR THE TAX PROFESSIONAL — January 2004 • Vol. 23, No. 1

KRC Improves Individual Income Tax Collection Through Amended Regulation

Changes to Regulation 103 KAR 18:070 will make collection of individual income tax more timely and less burdensome for nonresident individuals doing business in Kentucky through a partnership or S corporation. In addition, the withholding rate on gambling winnings is increased to reflect the 1990 elimination of federal income tax as a deduction. KRC has seen an increase in noncompliance because not enough tax or no tax was withheld to pay the liabilities.

Effective Nov. 25, 2003, Regulation 103 KAR 18:070 is amended to increase the withholding on gambling winnings from 4 percent to 6 percent and to require pass-through entities to withhold income tax at 6 percent on Kentucky net distributive share income of nonresident individual partners and shareholders (“owners”).

Gambling Winnings

Every person making a payment of gambling winnings that is subject to federal tax withholding must deduct and withhold Kentucky income tax from the payment. The amount withheld is 6 percent of the proceeds paid (the amount of winnings minus the amount of the bet).

Gambling winnings of more than $5,000 from the following sources are subject to income tax withholding.

- Any sweepstakes, wagering pool, or lottery.
- Any other wager, if the proceeds are at least 300 times the amount of the bet.

Gambling winnings from bingo, keno, and slot machines are generally not subject to federal income tax withholding.

Net Distributive Share Income

For taxable years ending on or after Dec. 31, 2003, every pass-through entity required to file Form 765, Kentucky Partnership Income Return, or Form 720S, Kentucky S Corporation Income and License Tax Return, must withhold income tax on each nonresident individual partner, shareholder, or member. The amount of tax to be withheld is 6 percent of the net distributive share income apportioned to Kentucky. ***This is in addition to any employee wage withholding requirement***.

The pass-through entity is liable for the payment of the tax required to be withheld less any credits passed through to the individual that are reasonably expected to be claimed in the current tax year. The pass-through entity shall recover the amount of tax withheld from the member.

Withholding is not required if:

- the member’s net distributive share income is less than $1,000;
- the pass-through entity can demonstrate that the member’s net distributive share income is not subject to income tax; or
- the pass-through entity is a publicly traded partnership as defined by 26 U.S.C. 7704(b) of the Internal Revenue Code.

New Revenue Forms 40A201, Kentucky Nonresident Income Tax Withholding on Net Distributive Share Income Transmittal Report, and 40A200, Kentucky Nonresident Income Tax Withholding on Net Distributive Share Income, are used to report and pay the tax withheld. For forms and more information on this new withholding obligation, visit KRC’s Web site at www.revenue.ky.gov.

The reporting of net distributive share income and payment of tax due by the pass-through entity satisfies the filing requirement of Kentucky Revised Statute (KRS) 141.206 for a nonresident individual member whose only Kentucky source income is net distributive share income. The nonresident individual member may file a return to take advantage of the graduated tax rates and apply the tax withheld against tax imposed for the taxable year in which the income is reported.

The regulation may be viewed at http://www.lrc.state.ky.us/kar/103/018/070.htm.

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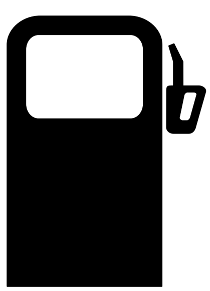
Disposition of Internal Revenue Code Section 179 Property by an S Corporation or Partnership

Beginning with tax returns filed for the calendar year ended Dec. 31, 2003, and after, gain (loss) from the disposition of property on which an Internal Revenue Code (IRC) Section 179 expense deduction was claimed will no longer be reported on Form 4797 or included in income reported on federal partnership or S corporation tax returns. Instead, details of each such disposition (i.e., description of asset, date acquired, date sold, sales price, cost basis, depreciation allowed, and prior Section 179 expense) will be reported separately to partners or shareholders as supplemental information on federal Schedule K-1. This income will ultimately be reported on federal returns of partners and shareholders of these pass-through entities.

For Kentucky partnership or S corporation returns, list all asset disposition information as supplemental information for the Kentucky Schedule K-1. This information should be in the same format as the information for the federal supplemental K-1 information, but the amounts should be adjusted to reflect Kentucky amounts for depreciation and prior Section 179 expense. This will provide the necessary Kentucky information to all partners or shareholders so they can file their Kentucky individual returns with respect to dispositions of assets with prior Section 179 expense.

Special withholding rules—-for nonresident partners or shareholders, ordinary income, Section 1231 gains for the disposition of assets and recapture of Section 179 expense must be computed and included in the net distributive share income base for withholding purposes.

Gasoline Excise Tax Rate



Under KRS 138.210 and 138.220, KRC 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 October 2003 and a grade and formulation weighted average reflective of gasoline consumption patterns.

For the quarter commencing January 1, 2004, the rate remains 16.4 cents per gallon, which includes the 1.4 cent Petroleum Storage Tank Environmental Assurance Fee.

Enterprise Zone Update

Effective Dec. 31, 2003, the Louisville and Hickman enterprise zones will expire. KRC is revising the enterprise zone certificates (Forms 51A151 and 51A152) to remind both purchasers and vendors of these changes. Qualified businesses in the Louisville and Hickman enterprise zones will no longer be able to buy machinery and equipment exempt from sales and use tax effective Jan. 1, 2004. Likewise, building material purchases for installation in these zones will be taxable as of Jan. 1, 2004. For a sale to qualify as exempt for use in the Louisville or Hickman zone, there must be either the transfer of title or possession of the property to the customer on or before Dec. 31, 2003. In addition, the appropriate exemption form must be provided to the supplier.

Consolidated Corporation Income Tax Returns

KRS 141.200(3) allows an affiliated group of corporations to elect to file a consolidated Kentucky corporation income tax return. The common parent corporation on behalf of all members of the affiliated group must make the election. Kentucky Administrative Regulation 103 KAR 16:200 provides the procedures to be followed in making the election. The initial election must be made on Form 722, Election to File Consolidated Kentucky Corporation Income Tax Return. The election form must be submitted to KRC with a timely filed Form 720, Corporation Income and License Tax Return, for the first taxable year for which the election is made.

The election to file a consolidated return is binding on both the affiliated group and KRC for a period of eight years. The eight-year election period has expired for those corporations whose election period began with the Dec. 31, 1995, return.

Upon the expiration of an election period, the affiliated group may continue to file consolidated corporation income tax returns by timely filing a return for the first taxable year that begins after the expiration of an election period. Checking the consolidated box on page 1 of Form 720 will constitute a new election and a new eight-year election period will begin. A new Form 722 is not required. However, a copy of the initial election form must be attached to the return.

If the affiliated group does not make a new election upon the expiration of an eight-year election period, each member of the affiliated group subject to Kentucky corporation income tax in accordance with KRS 141.040 must file a separate return.

TAX CALENDAR 2004

JANUARY * * * APRIL

NOTE: If a return due date falls on a scheduled holiday or weekend, returns will be due the next working day.

Month	Day	Return
January	15	Estimated Corporation Income Tax/One Half Est. (FY ending 7/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 1/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 4/30)
	15	Estimated Tax/Individuals/One Fourth Est.
	20	Coal Severance Tax Returns (December Payment)
	20	Oil Production Tax Returns (December Payment)
	20	Monthly Sales Tax Returns (December Payment)
	20	Quarterly Sales Tax Returns
	20	Annual Sales Tax Returns
	20	Health Care Provider Tax Returns (December Payment)
	26	Monthly Motor Fuels Tax Returns (December Payment)
	26	Monthly Sales Tax Returns (Accelerated Payment)
February	2	Income Tax Withholding Returns/Electronic Funds Transfer (EFT) Filers/Annual Reconciliation
	2	Minerals and Gas Severance Tax Returns (December Payment)
	2	Monthly Income Tax Withholding Returns (December Payment and K-2s)
	2	Quarterly Income Tax Withholding Returns (Quarterly Payment and K-2s)
	2	Annual Income Tax Withholding Returns (Annual Payment and K-2s)
	2	Annual Report of Distilled Spirits in Bonded Warehouses (as of 1/1/04)
	10	Twice-Monthly Income Tax Withholding Returns (January 1 - January 31 Payment/EFT Payment)
	16	Estimated Corporation Income Tax/One Half Est. (FY ending 8/31)
	16	Estimated Corporation Income Tax/One Fourth Est. (FY ending 2/28)
	16	Estimated Corporation Income Tax/One Fourth Est. (FY ending 5/31)
	16	Monthly Income Tax Withholding Returns (January Payment)
	20	Coal Severance Tax Returns (January Payment)
	20	Oil Production Tax Returns (January Payment)
	20	Monthly Sales Tax Returns (January Payment)
	20	Health Care Provider Tax Returns (January Payment)
	25	Twice-Monthly Income Tax Withholding Returns (February 1 - February 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (January Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)
March	1	Minerals and Gas Severance Tax Returns (January Payment)
	1	Watercraft Property Tax Return (as of 1/1/04)
	10	Twice-Monthly Income Tax Withholding Returns (February 16 - February 28 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 9/30)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 3/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 6/30)
	15	Monthly Income Tax Withholding Returns (February Payment)
	15	Bank Franchise Tax Returns
	22	Coal Severance Tax Returns (February Payment)
	22	Oil Production Tax Returns (February Payment)
	22	Monthly Sales Tax Returns (February Payment)
	22	Health Care Provider Tax Returns (February Payment)
	25	Twice-Monthly Income Tax Withholding Returns (March 1 - March 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (February Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)
April	1	Minerals and Gas Severance Tax Returns (February Payment)
	1	Electric Plant Board Property Tax Returns (as of 1/1/04)
	12	Twice-Monthly Income Tax Withholding Returns (March 16 - March 31 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 10/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 4/30)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 7/31)
	15	Monthly Income Tax Withholding Returns (March Payment)
	15	Quarterly Estimated Tax Returns/Individuals (One Fourth Payment)
	15	Annual Individual Income Tax Returns
	20	Monthly Sales Tax Returns (March Payment)
	20	Quarterly Sales Tax Returns
	20	Coal Severance Tax Returns (March Payment)
	20	Oil Production Tax Returns (March Payment)
	20	Health Care Provider Tax Returns (March Payment)
	26	Twice-Monthly Income Tax Withholding Returns (April 1 - April 15 Payment/EFT Payment)
	26	Monthly Motor Fuels Tax Returns (March Payment)
	26	Monthly Sales Tax Returns (Accelerated Payment)

TAX CALENDAR 2004

MAY * * * AUGUST

May	3	Income Tax Withholding Returns/Electronic Funds Transfer (EFT) Filers/First Quarter Reconciliation
	3	Quarterly Income Tax Withholding Returns
	3	Minerals and Gas Severance Tax Returns (March Payment)
	3	Public Service Company Property Tax Returns (as of 12/31/03)
	3	Railroad Car Line Property Tax Returns (as of 12/31/03)
	10	Twice-Monthly Income Tax Withholding Returns (April 16 - April 30 Payment/EFT Payment)
	17	Intangible Personal Property Tax Return (Taxpayer will be billed later)
	17	Tangible Personal Property Tax Return (Taxpayer will be billed later)
	17	Estimated Corporation Income Tax/One Half Est. (FY ending 11/30)
	17	Estimated Corporation Income Tax/One Fourth Est. (FY ending 5/31)
	17	Estimated Corporation Income Tax/One Fourth Est. (FY ending 8/31)
	17	Monthly Income Tax Withholding Returns (April Payment)
	20	Monthly Sales Tax Returns (April Payment)
	20	Coal Severance Tax Returns (April Payment)
	20	Oil Production Tax Returns (April Payment)
	20	Health Care Provider Tax Returns (April Payment)
	25	Twice-Monthly Income Tax Withholding Returns (May 1 - May 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (April Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)
June	1	Minerals and Gas Severance Tax Returns (April Payment)
	10	Twice-Monthly Income Tax Withholding Returns (May 16 - May 31 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 12/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 6/30)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 9/30)
	15	Estimated Tax/Individuals/One Fourth Est.
	15	Monthly Income Tax Withholding Returns (May Payment)
	21	Monthly Sales Tax Returns (May Payment)
	21	Coal Severance Tax Returns (May Payment)
	21	Oil Production Tax Returns (May Payment)
	21	Health Care Provider Tax Returns (May Payment)
	25	Twice-Monthly Income Tax Withholding Returns (June 1 - June 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (May Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)
July	1	Minerals and Gas Severance Tax Returns (May Payment)
	1	Cigarette License Annual Renewal Applications and License Fee
	12	Twice-Monthly Income Tax Withholding Returns (June 16 - June 30 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 1/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 7/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 10/31)
	15	Monthly Income Tax Withholding Returns (June Payment)
	20	Coal Severance Tax Returns (June Payment)
	20	Oil Production Tax Returns (June Payment)
	20	Monthly Sales Tax Returns (June Payment)
	20	Quarterly Sales Tax Returns
	20	Health Care Provider Tax Returns (June Payment)
	26	Twice-Monthly Income Tax Withholding Returns (July 1 - July 15 Payment/EFT Payment)
	26	Monthly Motor Fuels Tax Returns (June Payment)
	26	Monthly Sales Tax Returns (Accelerated Payment)
	30	Income Tax Withholding Returns/Electronic Funds Transfer (EFT) Filers/Second Quarter Reconciliation
	30	Minerals and Gas Severance Tax Returns (June Payment)
	30	Quarterly Income Tax Withholding Returns
August	10	Twice-Monthly Income Tax Withholding Returns (July 16 - July 31 Payment/EFT Payment)
	16	Estimated Corporation Income Tax/One Half Est. (FY ending 2/28)
	16	Estimated Corporation Income Tax/One Fourth Est. (FY ending 8/31)
	16	Estimated Corporation Income Tax/One Fourth Est. (FY ending 11/30)
	16	Monthly Income Tax Withholding Returns (July Payment)
	20	Coal Severance Tax Returns (July Payment)
	20	Oil Production Tax Returns (July Payment)
	20	Monthly Sales Tax Returns (July Payment)
	20	Health Care Provider Tax Returns (July Payment)
	25	Twice-Monthly Income Tax Withholding Returns (August 1 - August 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (July Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)

TAX CALENDAR 2004

SEPTEMBER * * * DECEMBER

September	1	Minerals and Gas Severance Tax Returns (July Payment)
	10	Twice-Monthly Income Tax Withholding Returns (August 16 - August 31 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 3/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 9/30)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 12/31)
	15	Estimated Tax/Individuals/One Fourth Est.
	15	Monthly Income Tax Withholding Returns (August Payment)
	20	Coal Severance Tax Returns (August Payment)
	20	Oil Production Tax Returns (August Payment)
	20	Monthly Sales Tax Returns (August Payment)
	20	Health Care Provider Tax Returns (August Payment)
	27	Twice-Monthly Income Tax Withholding Returns (September 1 - September 15 Payment/EFT Payment)
	27	Monthly Motor Fuels Tax Returns (August Payment)
	27	Monthly Sales Tax Returns (Accelerated Payment)
October	1	Minerals and Gas Severance Tax Returns (August Payment)
	11	Twice-Monthly Income Tax Withholding Returns (September 16 - September 30 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 4/30)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 1/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 10/31)
	15	Monthly Income Tax Withholding Returns (September Payment)
	20	Coal Severance Tax Returns (September Payment)
	20	Oil Production Tax Returns (September Payment)
	20	Monthly Sales Tax Returns (September Payment)
	20	Quarterly Sales Tax Returns
	20	Health Care Provider Tax Returns (September Payment)
	25	Twice-Monthly Income Tax Withholding Returns (October 1 - October 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (September Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)
November	1	Income Tax Withholding Returns/Electronic Funds Transfer (EFT) Filers/Third Quarter Reconciliation
	1	Minerals and Gas Severance Tax Returns (September Payment)
	1	Quarterly Income Tax Withholding Returns
	10	Twice-Monthly Income Tax Withholding Returns (October 16 - October 31 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 5/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 2/28)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 11/30)
	15	Monthly Income Tax Withholding Returns (October Payment)
	22	Coal Severance Tax Returns (October Payment)
	22	Oil Production Tax Returns (October Payment)
	22	Monthly Sales Tax Returns (October Payment)
	22	Health Care Provider Tax Returns (October Payment)
	25	Twice-Monthly Income Tax Withholding Returns (November 1 - November 15 Payment/EFT Payment)
	25	Monthly Motor Fuels Tax Returns (October Payment)
	25	Monthly Sales Tax Returns (Accelerated Payment)
December	1	Minerals and Gas Severance Tax Returns (October Payment)
	10	Twice-Monthly Income Tax Withholding Returns (November 15 - November 30 Payment/EFT Payment)
	15	Estimated Corporation Income Tax/One Half Est. (FY ending 6/30)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 3/31)
	15	Estimated Corporation Income Tax/One Fourth Est. (FY ending 12/31)
	15	Monthly Income Tax Withholding Returns (November Payment)
	20	Coal Severance Tax Returns (November Payment)
	20	Oil Production Tax Returns (November Payment)
	20	Monthly Sales Tax Returns (November Payment)
	20	Health Care Provider Tax Returns (November Payment)
	30	Twice-Monthly Income Tax Withholding Returns (December 1 - December 15 Payment/EFT Payment)
	30	Monthly Motor Fuels Tax Returns (November Payment)
	30	Monthly Sales Tax Returns (Accelerated Payment)

2003 Federal/Kentucky Individual Income Tax Differences

Kentucky income tax law is based on the federal income tax law in effect on December 31, 2001. The Revenue Cabinet generally follows the administrative regulations and rulings of the Internal Revenue Service in those areas where no specific Kentucky law exists.

The chart below provides a quick reference guide to the major federal/Kentucky differences. It is not intended to be all inclusive. Items not listed may be referred to the Revenue Cabinet to determine Kentucky tax treatment.

PROVISION	FEDERAL TAX TREATMENT	KENTUCKY TAX TREATMENT
1. Interest from Federal Obligations	Taxable	Exempt
2. Retirement Income from:		Partially exempt if retired after December 31, 1997; exempt if retired before January 1, 1998; Schedule P may be required
Commonwealth of Kentucky Retirement Systems	Taxable	
Kentucky Local Government Retirement Systems	Taxable	
Federal and Military Retirement Systems	Taxable	
3. Pensions and Annuities Starting After 7/1/86 and Before 1/1/90	3-year recovery rule eliminated	3-year recovery rule retained
4. Other Pension and Annuity Income	Taxable	100% excludable up to $39,400; Schedule P may be required
5. Benefits from U.S. Railroad Retirement Board	May be taxable	Exempt; Schedule P may be required
6. Social Security Benefits	May be taxable	Exempt
7. Capital Gains on Sale of Kentucky Turnpike Bonds	Taxable	Exempt
8. Other States' Municipal Bond Interest Income	Exempt	Taxable
9. Kentucky Local Government Lease Interest Payments	Taxable	Exempt
10. Long-Term Care Insurance Premiums	Limited deduction as self-employed health insurance	100% adjustment to gross income
11. Medical and Dental Insurance Premiums	Limited deduction as self-employed health insurance	100% adjustment to gross income
12. Capital Gains on Property Taken by Eminent Domain	Taxable	Exempt
13. Election Workers—Income for Training or Working at Election Booths	Taxable	Exempt
14. Artistic Contributions	Noncash contribution allowed as itemized deduction	Appraised value allowed as itemized deduction or adjustment to income
15. State Income Taxes	Deductible	Nondeductible
16. Leasehold Interest—Charitable Contribution	May be deductible	Deductible; Schedule HH required
17. Kentucky Unemployment Tax Credit	No credit allowed	$100 per certified employee; Schedule UTC required
18. Work Opportunity Credit (federal Form 5884)	Tax credit allowed; wage expense reduced by amount of credit	No credit allowed; entire wage expense is deductible
19. Welfare to Work Credit (federal Form 8861)	Tax credit allowed; wage expense reduced by amount of credit	No credit allowed; wage expense reduced by amount of federal credit
20. Child and Dependent Care Credit	Tax credit based on expenses	20% of federal credit
21. Low Income Credit	No credit allowed	Decreasing tax credit allowed
22. Recycling and/or Composting Equipment Tax Credit	No credit allowed	Tax credit allowed; Schedule RC or RC(K-1) required
23. Taxpayer who may be Claimed as Dependent on Another's Return (i.e., full-time student)	May not claim self	May claim self
24. Child's Income Reported by Parent	Permitted; taxed at parent's rate	Not permitted
25. National Tobacco Settlement and TLAP Income	Taxable	Exempt
26. Skills Training Investment Tax Credit	No credit allowed	Tax credit allowed; Schedule TC required
27. Kentucky Investment Fund Tax Credit	No credit allowed	Tax credit allowed; Schedule TC required
28. Employer GED Incentive Tax Credit	No credit allowed	Tax credit allowed; Schedule TC required
29. Bonus Depreciation/Additional Section 179	Deductible	Nondeductible
30. Educator Expenses	Deductible	Nondeductible

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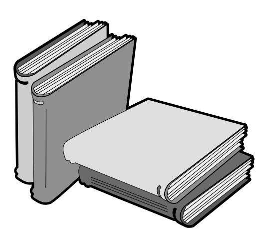

Court Cases Update

Property Tax—On Nov. 18, 2003, the Kentucky Board of Tax Appeals (KBTA) granted summary judgment in KRC's favor in ***Annox, Inc. v. Revenue Cabinet***, K02-R-20, a public service corporation property tax case.

The taxpayer is a switchless reseller of residential local (intrastate) telephone service and thus is a telephone company subject to ad valorem tax assessment as a public service corporation pursuant to KRS 136.120(1). It is a Georgia corporation authorized to do business in Kentucky and its principal place of business is in Tennessee.

As a telephone company, the taxpayer is a "utility" subject to regulation by the Kentucky Public Service Commission (PSC) and has been authorized by the PSC to offer telephone service in Kentucky. The taxpayer has accordingly filed with the PSC a tariff of its rates and charges for its telephone services.

During the tax year in question, 2001, the taxpayer provided telephone service to 592 customers in Kentucky. It earned gross income of $333,243.44 for 2001 from its Kentucky customers.

The taxpayer did not own any telephone equipment in Kentucky nor did it have any employees operating in Kentucky. It solicited customers by direct mail advertising and a Web page.

Telephone service is furnished by the taxpayer to its customers via interconnection agreements with Bell South and GTE. These agreements give the taxpayers unlimited access to the Bell South and GTE physical networks located in Kentucky. Pursuant to these agreements, the taxpayer can have an unlimited number of customers in Kentucky; however, it is required to pay GTE and Bell South for each customer. Installation of the taxpayer's telephone service and any needed repairs are performed by Bell South employees on the taxpayer's behalf. Bell South employees also perform disconnection of telephone service if a customer fails to pay the taxpayer for the telephone service.

The taxpayer challenged its public service corporation ad valorem tax assessment on the ground that it did have not have a substantial nexus with the Commonwealth of Kentucky, as required by the U.S. Constitution's Commerce Clause. Specifically, the taxpayer argued that it did not have the physical presence in Kentucky required by the U.S. Supreme Court's decision in ***Quill Corporation v. North Dakota***, 504 U.S. 298 (1992).

The KBTA ruled that the physical presence test announced in ***Quill*** applies only to sales and use taxes. Instead, the focus of the Commerce Clause's substantial nexus requirement in non-sales and use tax cases is whether the activities performed in Kentucky on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for its services.

In this case, the taxpayer has a substantial nexus with Kentucky by virtue of its right to use the physical networks of Bell South and GTE and the right to operate in Kentucky granted it by the PSC. These rights form its operating property subject to Kentucky ad valorem tax assessment under KRS 136.115(2) and 136.120.

Furthermore, any judicial construction of the Commerce Clause is subject to alteration by Congress. In this context, Congress through its enactment of the Telecommunication Act of 1996 has recognized that switchless resellers such as the taxpayer have substantial nexus with the states in which they offer their telephone services and are subject to the regulatory authority of state commissions such as the PSC.

In any event, the taxpayer did indeed have a physical presence with Kentucky through its utilization of Bell South employees in Kentucky. This relationship with Bell South established a physical presence in, and thus substantial nexus with, Kentucky.

Finally, the KBTA rejected the taxpayer's argument that the tax violated the nexus requirement of the U.S. Constitution's Due Process Clause. This nexus requirement does not necessitate a showing of physical presence, but instead calls for a demonstration that the taxpayer has substantial connections with Kentucky that constitute the purposefully availing itself of the benefits of an economic market in Kentucky.

In this case, it is undisputed that the taxpayer has purposefully directed its business toward Kentucky citizens. The assessment in question therefore does not violate the Due Process Clause.

This decision is not yet final. The taxpayer has appealed the KBTA's decision to the Franklin Circuit Court.

In ***Revenue Cabinet v. Comcast Cablevision of the South***, 2002-CA-001524 and 2002-CA-001579, the taxpayer was a cable television company with franchises in Kentucky and elsewhere. It was assessed, or valued, for ad valorem tax purposes as a public service corporation pursuant to KRS 136.115 *et seq*.

The taxpayer challenged its assessments for 1996 and 1997. It presented proof that the fair cash value of the taxpayer's Kentucky cable television "business enterprise" was $43,100,000 for 1996 and $44,500,000 for 1997. The taxpayer's expert witness, a Mr. Kane, separated this value into "two buckets," one he characterized as the taxpayer's operating property and the other he termed the taxpayer's nonoperating property. The operating property "bucket" was assigned a value of $26,000,000 for 1996 and $23,300,000 for 1997. The nonoperating property "bucket" was assigned a value of $17,100,000 for 1996 and $21,200,000 for 1997. Nonoperating property is subject to far lower tax rates than operating property.

The KBTA agreed with the taxpayer, ruling that substantial portions of the assessments in question were classifiable as nonoperating property, and the Franklin Circuit Court affirmed. In an opinion rendered on Nov. 14, 2003, the Kentucky Court of Appeals reversed the decisions of the circuit court and KBTA.

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Court Cases Update *(continued from page 8)*

The question presented was one of law. On appeal, KRC and taxpayer agreed on the "business enterprise value" reached by the taxpayer's expert. The question thus became the legal effect of this value and the classifications made by the taxpayer's expert.

Under KRS 136.120(1), "[e]very...cable television company shall annually pay a tax on its operating property to the state and to the extent the property is liable to taxation shall pay a local tax thereon to the county, incorporated city, and taxing district in which its operating property is located." Operating property is further defined in KRS 136.115(2) to include both the operating tangible property and the franchise.

The court held that the property the taxpayer's alleged nonoperating property was really part of the franchise assessable as part of the taxpayer's operating property. The court stated:

> After considering the statutory scheme pertaining to the public service corporation property tax, Ky. Const. §172, and Kentucky case law, we conclude that for the purposes of taxation under KRS 136.120, a "franchise" is the earning value ascribed to the capital or a domestic public service corporation by reason of its operation as a domestic public service corporation. It comprises the operating property and is assessed by the [KRC] by its fair cash value as a unit. In this case, the franchise is the earning value ascribed to [the taxpayer's] capital by reason of its operation as a cable television provider. Said another way, the value of the franchise is determined by subtracting the assessed value of the tangible operating property from the "capital stock," which is the "entire operating property from the "capital stock," which is the "entire operating property, real and personal, tangible and intangible, assets on hand, and its franchise as well."... Thus, the business enterprise value reached in the Kane appraisal is the total of Comcast's operating property—the operating tangible property and the franchise. As assessed by Kane and agreed to by the [KRC], it is the price at which a willing buyer would buy and a willing seller would sell an entire business as of the lien date. The fair cash value of [the taxpayer's] operating property is $43,100,000 for 1996 and $44,500,000 for 1997.

The Court of Appeals further held that nonoperating intangible property is intangible property, such as certificates of stock, bonds, or copyrights, that a public service corporation taxpayer does not use in the provision of its public service. In this case, there was no question but that the taxpayer was engaged solely in the provision of cable television, a public service enumerated in KRS 136.120(1).

The Court of Appeals also found it significant that the taxpayer listed no nonoperating property on its public service corporation property tax returns, as it was legally bound to do so under KRS 136.130.

This decision by the Court of Appeals is not yet final. The taxpayer has filed a motion for discretionary review of this decision with the Kentucky Supreme Court.

In a decision rendered on Dec. 4, 2003, in ***Monumental Life Insurance Company (successor in interest to Commonwealth Life Insurance Company) v. Revenue Cabinet***, K00-R-23, the KBTA upheld KRC's denial of additional refunds of taxes paid by the taxpayer pursuant to KRS 136.320 ("the capital stock tax") for Jan. 1, 1990, through Dec. 31, 1996, and KRC's assessment of additional capital stock tax for Jan. 1, 1995, through Dec. 31, 1998.

The capital stock tax is imposed by KRS 136.320 upon the taxable capital of domestic life insurance companies. The city and county in which the domestic life insurance company had its principal office are also permitted to levy taxes upon this taxable capital.

Under KRS 136.320, taxable capital is determined by deducting taxable reserves from capital, less exempt intangible personal property. Capital includes shares of stock in other corporations. "Exempt intangible personal property" included stock exempted by KRS 136.030(1), namely stock held in corporations paying property taxes to the Commonwealth of Kentucky on at least 75 percent of their property. The taxable reserves are calculated by means of a ratio that employs capital and exempt intangible personal property.

The taxpayer sought refunds of capital stock tax based upon the United States Constitution's Commerce Clause and the Kentucky Supreme Court's ***St. Ledger*** decision in particular. That decision held that KRS 136.030(1) was unconstitutional as discriminatory against interstate commerce.

KRC allowed the taxpayer refunds in the amount of $1,470,357.40, a figure arrived at by treating all stock as exempt intangible personal property. The taxpayer protested, asserting that it was entitled to an additional $6,751,758.46 on the theory that all the stock it owned should be excluded from capital in the first place, instead of being included and then exempted.

The KBTA's decision rejects this argument. It rules that stock is clearly included in capital under KRS 136.320. ***St. Ledger*** did not invalidate this provision of KRS 136.320, but instead held unconstitutional the discriminatory provision of KRS 136.030(1). The taxpayer's exclusion theory also reflects a miscalculation of the capital stock tax by failing to allocate to taxable reserves its proportionate share of the stock.

The KBTA's decision further rules that the assessment at issue in this case was proper. As a life insurance company, the taxpayer was required by law to file an annual statement ("the Blue Book") with the Kentucky Department of Insurance and "if applicable," an annual statement of separate accounts ("the Green Book"). The taxpayer reported the separate accounts as a single line item on its Blue Books for the years in question, but did not list them on its capital stock return. The

(continued on page 10)

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Green Books detailing these separate accounts were not provided to KRC until the taxpayer filed its 1998 return.

The KBTA's decision holds that the separate accounts were property and capital assessable for ad valorem tax purposes under Ky. Const. §172 and KRS 136.320, which imposes and authorizes ad valorem or property taxes. Under KRS 304.15-390(6), this property was owned by the taxpayer. Accordingly, KRC's assessment of these separate accounts as omitted property under KRS 136.320 was proper.

This decision is not yet final. The taxpayer has appealed the KBTA's decision to the Franklin Circuit Court.

Sales Tax—At issue in ***Griffin Industries, Inc. v. Revenue Cabinet***, K02-R-5, K02-R-6, and K02-R-8 was the application of the sales and use tax exemption for recycling machinery, KRS 139.480(23), to machinery purchased by the taxpayer for use in its rendering business and to repair and replacement parts purchased for machinery used in both the taxpayer's rendering business and its collection of waste material. The KBTA's Dec. 5, 2003, decision in this case upholds KRC's assessment of $99,648.31, plus interest, based upon its denial of the applicability of the exemption.

The taxpayer is in the business of the collection and rendering of dead animals, meat scraps, and other food wastes, such as fat and grease from restaurants. The KBTA found that in this business, the taxpayer acts in two capacities. First, it acts as a recycler by collecting waste animal and bakery products, storing the material, compressing the material, and transporting the material to rendering plants in Kentucky. Once the waste material arrives at the rendering plant, the taxpayer acts as a manufacturer (its second capacity) when it takes the raw material (animal and bakery waste), processes it, adds other materials to the processed waste, and produces a final, finished product that is marketed and sold to consumers.

The KBTA's decision rules that the machinery used in the taxpayer's rendering business is not exempt under KRS 139.480(23). To be exempt under that provision of the sales and use tax law, the machinery must be "primarily used for recycling purposes." The machinery at the taxpayer's rendering plant is used for manufacturing, not recycling.

The KBTA further holds that the repair and replacement parts for machinery used in both the rendering plant and the waste collection are also not exempt under KRS 139.480(23). The term "machinery" in KRS 139.480(23) does not embrace repair and replacement parts. Items used to repair machines cannot be considered to be the machines themselves and thus do not fall under this exemption from sales and use tax.

This decision is not yet final. The taxpayer has appealed the KBTA's decision to the Campbell Circuit Court.

In ***Whayne Supply Company v. Revenue Cabinet***, K02-R-40, at issue were three exemption certificates the taxpayer-seller had received in connection with Kentucky retail sales. Under KRS 139.490, a seller is relieved of liability for sales and use tax if it accepts in good faith from a purchaser a written certificate that the property purchased will be used in a tax-exempt manner or for a tax-exempt purpose and maintains a file of these certificates in accordance with KRS 139.720.

In this case, the KBTA granted summary judgment in the KRC's favor, ruling that the three certificates "were either incomplete or obviously invalidly completed, and none [met] the threshold requirement of KRS 139.490 for a written statement that the property will be used in a manner/purpose that makes the sale exempt from tax." For example, one of the certificates, purporting to rely upon the exemption for machinery for new and expanded industry, stated that the machinery or equipment in question was going to West Virginia for installation, a circumstance that on its face precluded the application of that exemption. See Kentucky Administrative Regulation 103 KAR 30:120 §1(4). A seller that accepts an incomplete certificate or an obviously invalid certificate is not entitled to protection from sales tax liability, the KBTA ruled.

This Nov. 10, 2003, decision is now final.

KRC Creates Web-Based Filing System for Wage and Tax Statements (Form W-2) and Changes Electronic Filing Requirements

Beginning with calendar year 2003, any employer who issues 100 or more W-2 forms annually is required to utilize an acceptable form of electronic or magnetic media filing. Employers with fewer than 100 W-2 forms are encouraged, but not required, to utilize electronic or magnetic media filing. Submission of wage and tax information must be filed on or before Jan. 31, 2004. **Regulation 103 KAR 18:050**

KRC now offers a secure Web site as the preferred method of submitting employee wage and tax information. Using the Web site offers smooth and efficient submission of wage and tax information. Use of this Web site will not only streamline the processing of the wage and tax information for KRC, but it offers the employer an easy and secure way to meet the filing requirements.

This service is provided **at no cost** and only requires the employer's PC to have Microsoft® Internet Explorer, or any other compatible Web browser. There are no hardware restrictions and no software installations required.

To use the Web site, an identification number (PIN) is required, which KRC will assign when the employer declares its intention to send annual wage and tax reports via the Web. To register, use Form 42A808, Authorization to Submit Employees Annual Wage and Tax Statements Via KRC Web Site. This form may be obtained from KRC's Web site at *http://revenue.ky.gov/filew2.htm* or by calling the Taxpayer Assistance Branch at (502) 564-4581.

Employers who registered to use the FTP software from previous years are already registered to use the Web site. The PIN will not change. If you have forgotten your PIN, send an e-mail to *krc.withholding@mail.state.ky.us*.

NOTE: The FTP program will no longer work for any tax year.

If you want more information on how to get started, visit the Web site, see the *Frequently Asked Questions*, or send an e-mail via the *Contact KRC* page. You can also contact the Withholding Tax Section by phone at (502) 564-7287, by fax at (502) 564-3685, and by mail at Kentucky Revenue Cabinet, P.O. Box 181, Station 57, Frankfort, KY 40602-0181.

Online Filing of Sales and Use Tax Returns

Online filing is now ready and available to taxpayers who wish to file their sales and use tax returns electronically. By filing electronically, there will be no math errors, no postage, no worrying about the return being received timely, and no waiting on your paper return to arrive. Once you begin filing electronically, a paper return will no longer be received in the mail.

Previously filed returns for the past 12 months will be available for review. Payment may also be submitted electronically via E-check or credit card to further expedite the filing and payment process. To register, access online filing at KRC's Web site at *www.revenue.ky.gov*.

Find out more about this convenient and efficient method of reporting your sales and use tax by e-mailing *KRC.WebResponseETax@ky.gov* or calling (502) 564-5170. Online filing and payment of withholding tax will be implemented in the near future.

Kentucky Tax Alert is a bimonthly publication printed on recycled paper, the costs of which are paid from state funds.

Comments, suggestions and mailing list additions or corrections should be addressed to the Public Information and Communication Services Branch, Revenue Cabinet, Station 14, Frankfort, Kentucky 40620, (502) 564-4592.

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