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# Federal-State Income Tax Relationships-- Conformity of Kentucky's Personal Income Tax With the Federal Model

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# Federal-State Income Tax Relationships — Conformity of Kentucky's Personal Income Tax With the Federal Model

BY  
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AND  
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FEDERAL-STATE INCOME TAX  
RELATIONSHIPS-CONFORMITY OF  
KENTUCKY'S PERSONAL INCOME TAX  
WITH THE FEDERAL MODEL

INTRODUCTORY

State governments in the United States traditionally have utilized property taxation and various excise taxes as their chief sources of revenue. That this could not always continue was inevitable. With the development of modern industry, new wealth sources were created in forms other than property; there was at the same time a decline in the relative value of property compared with income available for consumption. Moreover, there has been an exploding need for domestic services supplied by states—in the fields of education, public safety, welfare, public health and the environment. Several significant factors have favored the taxation of income as a device to fill the growing gap between revenue needs and collections.<sup>1</sup> First, tax decision-makers have increasingly recognized the existence of forms of wealth other than real or tangible personal property, with its inherent drawbacks as a source of revenue. Second, the progressive income tax is peculiarly adapted to the distribution of the tax burden upon the basis of ability to pay, substituting a new

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<sup>1</sup> TAX POLICY LEAGUE, *THE PLACE OF STATE INCOME TAXATION IN THE REVENUE SYSTEMS OF THE STATE* (1935). The National Taxation Association had assumed that state and local governments must continue indefinitely to derive the chief portion of their revenues from the property tax; significantly, the League took the opposite view in the above report.

rationale for the traditional theory of benefits conferred, long considered by economists to be a major justification for the property tax. This is unlike the property tax which applies with frequent regressive effect in its relative burden upon the less wealthy classes of taxpayers. Third, an income tax permits the imposition of the tax burden upon net profits only by means of the allowance of deductions deemed appropriate. This feature is in sharp contrast to taxation of property, which is based upon a percentage of capital whether profitable or not. Finally, and perhaps most important, the federal income tax system (which was developed before most states adopted an income tax) affords the states a working model with definitions of income, deductions and exemptions, rate structures, and collection machinery. Thus a ready guideline is available to the states, enabling them to achieve an accurate and efficient administration of the income tax which could not be accomplished with other forms of taxation.

Following several short-lived predecessors elsewhere, Wisconsin enacted the first successful permanent state income tax in 1912.<sup>2</sup> Other states followed, but growth was slow.<sup>3</sup> Income taxation continued to be a relatively minor source of revenue for the states, usually being considered merely an alternate way to supplement revenue from property and excise taxes. Momentum gathered toward increased adoption of the income tax as a major source of revenue in the 1930's. More recently there has been a sharp rise in the use of income taxes by the states. Largely since World War II, various forms of income taxes have been imposed by numerous cities and municipalities. Today, forty-four states plus the District of Columbia have income tax statutes.<sup>4</sup>

Despite the recent widespread acceptance of the income tax as a source of revenue by most states, the rates generally have remained relatively low compared with the federal rates.<sup>5</sup> Certainly the gradations in progressivity of the rates imposed have remained less sharp. And there is a wide variation between the different states concerning the respective percentages of their

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<sup>2</sup> E. MELICHAR, *STATE INDIVIDUAL INCOME TAXES—IMPACT OF ALTERNATIVE PROVISIONS ON BURDENS, PROGRESSION AND YIELDS* 16 (1963) [hereinafter cited as MELICHAR].

<sup>3</sup> R. COODE, *THE INDIVIDUAL INCOME TAX* 4 (1964). MELICHAR, *supra* note 2, chs. II and III, at 3-43.

<sup>4</sup> CCH *STATE TAX GUIDE* ¶ 15-000 (1972).

<sup>5</sup> MELICHAR, *supra* note 2, at 37-43.

income tax revenue to the income tax revenue of the federal government.<sup>6</sup> Likewise the percentage of revenue derived from income taxation versus the total revenue from all state taxes has differed from state to state.<sup>7</sup>

The history of income taxation in the United States has been heavily laced with questions concerning duplication and fiscal overlap between the federal and state governments.<sup>8</sup> In 1908, five years before the sixteenth amendment assured the validity of the federal income tax, Professor Seligman predicted that the income tax would become in the first instance a national tax. This was part of the prediction of a gradual decline in the doctrine of supremacy of states' rights as a ground rule to govern division between federal and state governmental functions.<sup>9</sup> Since 1908 the federal income tax has indeed fulfilled Professor Seligman's predictions. For some years the income tax has been the most important single source of federal revenue. States ventured into the field reluctantly as money needs demanded and always to a lesser degree and with less steeply graduated rates than the federal government.<sup>10</sup> There were proposals made from time to time that the states should completely abandon taxation of income, leaving this source of revenue solely within the domain of the national government.<sup>11</sup> This, of course, never came to pass.

There have been, however, several recent developments which should be weighed together in attempting to project the future role of income taxes imposed by the states in relation to those by the federal government. First, judicial rulings in the past two years have focused attention on the limitations upon property taxation. Probably the most publicized decision has been *Serrano v. Priest*<sup>12</sup> which held that a state's allocation of revenues derived from taxation of property must, on constitutional grounds, be done on a statewide basis rather than by local school districts according to the valuation of property wealth of the respective

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<sup>6</sup> U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, TAX OVERLAPPING IN THE UNITED STATES 66 (M-11 1961) [hereinafter cited as U.S. ADVISORY COMM'N].

<sup>7</sup> MELICHAIR, *supra* note 2, at 26-37.

<sup>8</sup> U.S. ADVISORY COMM'N, *supra* note 6; Kamins, *Federally-Based State Income Taxes*, 9 NAT'L TAX J. 46, 54 (1956).

<sup>9</sup> E. SELIGMAN, *A Quarter Century's Progress in Taxation*, in *ESSAYS IN TAXATION* 345 (10th ed. 1931).

<sup>10</sup> U.S. ADVISORY COMM'N, *supra* note 6, at 55, 56, 58-62.

<sup>11</sup> H. SIMONS, *PERSONAL INCOME TAXATION* 214 (1938).

<sup>12</sup> 3 Cal.2d 585, 487 P.2d 1241 (1971).

district. Much discussion has followed as to alternative means of financing schools through taxation, and there have been other issues adjudicated placing limits on property taxation.<sup>13</sup> These limitations may mean increased emphasis upon the income tax as one of the alternative sources of revenue for schools.

Secondly, with the ink not yet dry on this analysis of the Kentucky income tax, revenue sharing became effective. A portion of federal income tax collections will now be shared with the states, and there is the option afforded qualified states of invoking existing federal collection and administrative machinery to enforce the state income tax laws. Clearly, the new legislation does not now contemplate an end to state income taxation in favor of relegating the entire field to the national government. In fact, provisions of the present revenue sharing system encourage states to levy their own income taxes. If revenue sharing is expanded, the implications for fiscal federalism are far-reaching.<sup>14</sup> We may yet come full circle from the time when income taxation by states was comparatively inconsequential. The trend toward increased state reliance upon use of the income tax may soon be shifting toward a single income tax imposed and collected by the federal system but shared to a large degree with the states through distribution of the revenue. Further, a state's ability to take advantage of the proffered assistance in collection and administration requires that the substantive income tax laws of the states which qualify must provide a high degree of conformity with the federal law.

Third, a recent decision of the Pennsylvania Supreme Court held unconstitutional the 1971 Pennsylvania state income tax law because it based the state tax upon the definition of taxable income in the *Internal Revenue Code* and thereby violated the state constitutional provision that ". . . taxes shall be uniform, upon the same class of subjects. . . ."<sup>15</sup> In the unlikely event

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<sup>13</sup> These alternatives are more fully discussed in *Fiscal Problems of Fractionated Governments: with Special Reference to Property Taxation*, 38 TAX POLICY 16 (1971), and *Present and Future Shock in Property Taxation*, 39 TAX POLICY 3 (1972).

<sup>14</sup> A good discussion appears in an article by Weidenbaum, *Revenue Sharing and the Future of Federalism*, in JOHN C. LINCOLN INSTITUTE/NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, PROBLEMS AND RESPONSE IN THE FEDERALISM CRISIS 34 (1971).

<sup>15</sup> *Amidon v. Kane*, 279 A.2d 53 (Pa. 1971); see Halby, *Is the Income Tax Unconstitutionally Discriminatory*, 58 A.B.A.J. 1291-93 (Dec. 1972).

that other states, such as Kentucky, may follow this case or that the federal courts will invalidate the entire federal income tax as lacking uniformity because of its numerous preferential provisions, a comprehensive reform of both federal and state income tax systems may be closer at hand than could ever be accomplished through legislative decision-making.

In the absence of federal preemption of the field, it seems desirable that state income tax structures be harmonized with the model provided by the federal law. There is a growing tendency to use the federal tax base. Starting with federal adjusted gross income as a base figure, the states have made varying adjustments. Only a few states have reached full conformity by enacting a state tax measured by a percentage of the federal tax.<sup>16</sup>

The higher the degree of conformity with the federal tax, the better, for two reasons. First, administration of the statute following federal administrative and judicial interpretation eases the job of revenue officials, promotes administrative convenience, and lessens the cost of collection. Intergovernmental interchange of information is most usable when the tax base and methods of computation are standardized. Second, a high degree of conformity eases the taxpayer's burden of compliance, improves his morale and prevents psychic frustration. It is a major premise of this article that the highest feasible conformity is desirable in the interest of both these objectives, administrative convenience for the revenue officials and reduced grief in compliance by taxpayers.<sup>17</sup>

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<sup>16</sup> An example of a state with a minimum of adjustments is one which as its only exceptions provides for the denial of the deduction for state income taxes or for the exemption from taxation of the interest on United States or state bonds, or both. Other examples of these deviations are collected in Kamins, *Federally-Based State Income Tax*, 9 NAT'L TAX J. 46 (1956).

It would be possible to provide for a fraction of the actual tax from the federal return, which fraction or percentage would remain constant notwithstanding variations in the federal tax, subject only to amendment by the state legislature. This is exemplified by the state of Alaska which now provides for a state tax of 16% of the federal amount.

It would also be possible to provide for a percentage of the federal tax, but with authority delegated to the state revenue commissioner or to a board to adjust the state percentage in order to maintain a constant state levy should the federal tax rates change. This, of course, involves a question of delegation of legislative functions to the executive branch of government. See discussion of the differing provisions which have been tried from time to time in various states in Kamins, *Federally-Based State Income Taxes*, 9 NAT'L TAX J. 46 (1956).

<sup>17</sup> These objectives are pointed out in U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, REPORT TO THE PRESIDENT 106 (1955) and U.S. ADVISORY COMM'N, *supra* note 6, ch. 6, at 55-77.



The Kentucky General Assembly in enacting the first income tax law in 1936 clearly intended to make full use of the federal model.<sup>18</sup> Both the broad outlines of the federal law and the general principles concerning income and deductions were followed, but with necessary variation to accommodate Kentucky policy. Subsequent amendments to the Kentucky law sometimes brought Kentucky in line with later federal changes, while some created additional variations. It was the 1954 Kentucky statute, however, which most clearly announced the firm policy of conforming the Commonwealth's income tax with the federal law. It provided specifically that computations of income for state tax purposes should be "as nearly as practicable identical with the calculations required for federal income tax purposes," and that the Department of Revenue should prescribe forms "substantially identical" with the federal forms except to the extent that differences between the two laws required otherwise.<sup>19</sup> Moreover, the 1954 legislation went so far as to state that "the administrative and judicial interpretations of the federal income tax law" should be applied as far as practicable.<sup>20</sup>

As just noted, there were some differences between the Kentucky and federal income tax bases at the time of the 1954 legislative announcement of the strong policy of conformity with

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<sup>18</sup> R. Jewert, *An Analysis of the Differences Between the Federal Income Tax and the Kentucky Income Tax*, October 1, 1962 (unpublished thesis in the Margaret I. King Library, University of Kentucky). For three articles dealing with the pre-1954 Kentucky income tax, which resembles the present law in many respects, see Lockyer, *Kentucky Income Tax Compared with Federal Income Tax*, 42 Ky. L.J. 368 (1954); Lockyer & Martin, *Some Kentucky Income Tax Discriminations*, 39 Ky. L.J. 377 (1951); Lockyer, *History of the Kentucky Income Tax*, 43 Ky. L.J. 461 (1955).

<sup>19</sup> R. Jewert, *supra* note 18. The enabling legislation provided: The department [of Revenue] shall prescribe forms substantially identical with those utilized by the Federal Government except to the extent required by differences between this chapter and its application. The department shall apply as far as practicable the administration and judicial interpretations of the Federal Income Tax law. Computations of income for purposes of this chapter shall be as nearly as practicable identical with the calculations required for federal income tax purposes. Ky. Acts ch. 79, § 6 (1954).

<sup>20</sup> The current statute, KY. REV. STAT. § 141.050(1) (1971) [hereinafter cited as KRS] reads as follows:

Except to the extent required by differences between this chapter and its application and the federal income tax law and its application, the administrative and judicial interpretation of the federal income tax law, computations of gross income and deductions therefrom, accounting methods, and accounting procedures, for purposes of this chapter shall be as nearly as practicable identical with those required for federal income tax purposes.

federal law. Some of these variations are based on federal and state constitutional provisions; others rest on established tax policy. Numerous other differences have arisen since the 1954 enactment either by mere failure to keep up with changes in the federal law or by deviations created purely by legislative choice.

In the following pages the provisions of the Kentucky individual income tax laws are described and analyzed in light of their conformity with and deviations from the federal law. A major purpose will be to weigh the feasibility of closer conformity in certain areas, balancing any strong state public policies justifying deviation against the interest of both taxpayer and state revenue officials in simplification of the tax structure.

## I. KENTUCKY TAXING JURISDICTION

A most obvious difference between the federal and any state tax is the jurisdiction or power to tax. While the federal power to tax extends nationwide, the Kentucky taxing power is limited to persons within its boundaries. As a result of the combination of a limited jurisdiction and a mobile society, with all states competing for their share of revenue, problems of interstate allocation and double taxation arise in state taxation which are not readily comparable to federal law.<sup>21</sup>

### A. *Residents*

The Kentucky Income Tax is levied on the "entire net income"<sup>22</sup> of "residents" of Kentucky.<sup>23</sup> A "resident" is one who is "domiciled" in Kentucky on the last day of the taxable year *or* "who maintains a place of abode in this state and spends in the aggregate more than 183 days of the taxable year in this state."<sup>24</sup> An individual is "domiciled" in this state upon establishment of a permanent residence here.<sup>25</sup> Once a domicile is established it continues until a new one is obtained and "is not changed by removal for a definite period or for incidental purposes."<sup>26</sup> Changing

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<sup>21</sup> See INT. REV. CODE of 1954 §§ 861-64, 871-96, 901-81 [hereinafter cited as IRC] for the provisions concerning taxation of income from sources within or without the United States.

<sup>22</sup> Net income as defined in KRS § 141.010(11).

<sup>23</sup> KRS § 141.025(1); Ky. Income Tax Reg. II-6-1 (1972).

<sup>24</sup> KRS § 141.010(17); Ky. Income Tax Reg. II-1-1 (1972).

<sup>25</sup> Ky. Income Tax Reg. II-1-3 (1972).

<sup>26</sup> *Id.*

domicile requires intent, actual removal, and establishment of a new abode.<sup>27</sup> Consistent with these principles, individuals domiciled in Kentucky when entering the armed services "continue to be liable for the payment of Kentucky Income Taxes on all income regardless of where their military services are performed" if no domicile is established in another state. Military personnel may change their domicile from Kentucky to another state but "[c]onclusive evidence must be submitted showing that their Kentucky domicile has been abandoned and a new domicile established in another state."<sup>28</sup>

### B. *Nonresidents*

A "nonresident" is defined as any individual not a resident.<sup>29</sup> The Kentucky tax in the case of a nonresident is levied "only upon the amount of income received by him from labor performed, business done<sup>30</sup> or from other activities in this state, and from

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<sup>27</sup> *Id.*

Although a number of residences can be claimed for various purposes at the same time, only one "domicile" may attach to a person at a particular time. To determine the "domicile" of a person requires subjective information, because not only must there be some physical act to establish a "domicile" but in addition there must be a mental determination that a particular place became a person's "domicile." Further, there must be an intent to make this location one of permanency and in the event a person is ever absent he must have an intent to return to such location.

[The] question of domicile is a difficult one of fact to be settled only by a realistic and conscientious review of the many relevant and frequently conflicting indicia of where a man's home is and according to the established modes of proof. The place where a man lives is properly taken to be his domicile until facts adduced establish the contrary. It is not an unreasonable burden upon the individual to require him to establish domicile elsewhere than in the taxing jurisdiction if he is to escape the tax sought to be imposed. If one has at any time become domiciled in a particular taxing jurisdiction, it is his burden to establish any change of status upon which he relies to escape the tax imposed by that jurisdiction. No one, single factor, such as the individual's oral declaration of intention or the maintenance of his voting, franchise, is controlling, but all facts which go to show the relations retained to one's former place of abode (where there has been a change) are relevant in determining domicile. Some of the factors to be considered in making such determination are nature of the position held, the manner of living, social and financial connections, retention and strength of affiliations in the community of origin, and payment of taxes in the old community which might be avoided by surrendering that domicile. *District of Columbia v. Murphy*, 314 U.S. 441 (1941).

1 CCH STATE TAX REP., KY. ¶ 10-061 (1972). See *Gorman v. Dept. of Revenue*, Ky. BTA (June 23, 1967); Ky. OP. ATT'Y GEN., March 10, 1942.

<sup>28</sup> Ky. Income Tax Reg. II-1-6 (1972).

<sup>29</sup> KRS § 141.010(18); Ky. Income Tax Reg. II-1-2 (1972).

<sup>30</sup> Income derived by nonresident horse owners from the sale of their race horses at the Lexington Summer Sales is not subject to the Kentucky income tax since such business is not regularly done within the state, and as an isolated sale, would not be subject to tax. KY. OP. ATT'Y GEN., May 16, 1950.

intangible property which has acquired a business situs in this state. . . ."<sup>31</sup> All other income received by a nonresident is excluded from the computation of Kentucky taxable income.<sup>32</sup> In order to qualify as a nonresident, the taxpayer "shall submit proof of his bona fide intention to reside permanently elsewhere before the last day of the taxable year, and that he has spent less than 183 days in Kentucky."<sup>33</sup> *Kentucky Income Tax Regulations* also provide that if a person moves out of Kentucky for a period of six months or less "it shall be construed that the removal from Kentucky was not intended to be permanent, and such person shall be considered a resident during the time in which his abode may have been elsewhere."<sup>34</sup> The regulations further provide that to establish nonresident status the Kentucky Department of Revenue may require the taxpayer "to furnish evidence of compliance with requirements of the other state with respect to taxation and qualifications as a resident citizen."<sup>35</sup> Any person residing in Kentucky and living in other states part of the year "will be considered [a] resident of Kentucky" unless he can show that he has a permanent abode in another state and has spent less than 183 days in Kentucky.<sup>36</sup>

### C. Part-Year Residents

An individual who is a resident of Kentucky for a portion of the taxable year and a nonresident for the remainder of the taxable year computes his tax in the manner prescribed for residents for that portion of the year he is a resident<sup>37</sup> and in the manner prescribed for nonresidents for that portion of the year he is a nonresident.<sup>38</sup> Thus, persons becoming Kentucky residents during the taxable year are subject to the Kentucky individual income tax on "(a) their entire net income from any source after becoming a Kentucky resident, and (b) their income

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<sup>31</sup> KRS § 141.020(4). "The situs of intangible personal property shall be at the residence of the real or beneficial owner and not at the residence of a trustee having custody or possession thereof." *Id.* See also Ky. Income Tax Reg. II-6-5 (1972).

<sup>32</sup> KRS § 141.020(4).

<sup>33</sup> Ky. Income Tax Reg. II-1-2 (1972).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> KRS § 141.020(6).

<sup>38</sup> KRS § 140.020(7). The Kentucky Department of Revenue has a special form available, Schedule T-1 Tax Computation For New Residents (42A740-511, 1-72), which instructs new residents how to prorate tax credits.

from Kentucky sources prior to becoming a Kentucky resident."<sup>39</sup> Individuals who were residents of Kentucky, but became non-residents during the taxable year must compute their Kentucky income tax on "(a) their entire net income from all sources while they are a Kentucky resident and (b) their income from Kentucky sources after becoming a nonresident."<sup>40</sup>

#### D. Reciprocal Tax Agreements

Kentucky, under the authority of *Kentucky Revised Statutes* § 141.070(3) [hereinafter cited as KRS], has entered into reciprocal tax agreements (RTA) with various states<sup>41</sup> which exempt residents of those states from the Kentucky income tax on salaries and wages earned in Kentucky.<sup>42</sup> Thus salaries and wages earned in Kentucky by a nonresident are not subject to Kentucky income tax if the nonresident is a resident of a state which has executed an RTA with Kentucky. Similarly, a Kentucky resident earning salaries and wages in an RTA state is exempt from that state's income tax on all such salaries and wages. It is necessary that all Kentucky residents working in an RTA state file a certificate of nonresidence with his employer in order to have his out-of-state income exempted from that state's withholding tax.<sup>43</sup> These agreements facilitate taxpayer compliance because they remove the burden of filing tax returns in more than one state, a burden which would require digesting separate tax laws and calculating sometimes cumbersome computations.

## II. CREDITS FOR INCOME TAXES PAID TO OTHER STATES

### A. Kentucky Residents

In order to avoid double taxation<sup>44</sup> of Kentucky residents, the

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<sup>39</sup> Ky. Income Tax Reg. II-6-2 (1972).

<sup>40</sup> Ky. Income Tax Reg. II-6-3 (1972).

<sup>41</sup> Indiana, Illinois, Michigan, Ohio, Virginia, West Virginia, Wisconsin. The Virginia agreement applies only to taxpayers who commute daily to their employment in the nonresident state. Ky. Income Tax Reg. II-1-7 (1972); Ky. Dep't of Revenue, Instructions and Tax Table for Filing 1972 Kentucky Individual Income Tax Return-Form 740 (1972).

<sup>42</sup> KRS § 141.070(3); Ky. Income Tax Reg. II-1-7 (1972).

<sup>43</sup> Ky. Income Tax Reg. II-1-7 (1972). This Certificate of Nonresidence "is the employer's authority to exempt the employee's income from withholding." A nonresident of Kentucky "must file Revenue Form 42A809, Certificate of Nonresidence, with his Kentucky employer to exempt his income from Kentucky withholding." *Id.* See KRS § 141.070(4).

<sup>44</sup> See Note, *Multi-State Taxation of Personal Income*, 111 U. PA. L. REV. 974 (1963).

law provides for a credit directly against the tax otherwise payable when income has been subjected to tax in Kentucky as well as a sister state. KRS § 141.070(1) provides that a resident of this state, who has income derived from sources within a sister state and who is liable for income tax to the sister state on income also subject to Kentucky tax, shall be entitled to a credit against his Kentucky tax in the amount of the tax paid to the sister state. This section further provides that the credit allowed must not reduce the Kentucky tax liability below the tax which would have been payable if the income from the sister state was ignored in computing the Kentucky tax due. However, no credit will be allowed under the above provision if the sister state allows non-resident taxpayers a credit for the Kentucky tax paid.<sup>45</sup> The reasoning behind this provision is similar to the justification for allowing these tax credits, *i.e.*, to prevent double taxation of income. This is accomplished by allowing a credit in only one of the concerned states. Kentucky will allow a credit to a Kentucky resident only when no credit is allowed by the foreign state.<sup>46</sup>

#### B. *Nonresidents*

KRS § 141.070(2) provides that all nonresidents with income from Kentucky sources which is taxable by Kentucky and also by their state of residence are entitled to a credit on their Kentucky nonresident return if their state of residence allows similar treatment to Kentucky residents or exempts Kentucky residents from taxation on income earned in that state.<sup>47</sup> The amount of the credit is computed by multiplying the fraction represented by the ratio of Kentucky income to total income taxed by the sister state times the tax paid to the resident state.<sup>48</sup> Thus, if Kentucky

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<sup>45</sup> KRS § 141.070(1).

<sup>46</sup> KRS § 141.070(1); *cf.* KRS § 141.070(2). The credit is allowed to Kentucky residents for taxes paid to the following states: Alabama, Alaska, Arkansas, Colorado, Delaware, Georgia, Hawaii, Illinois, Iowa, Kansas, Louisiana, Maine, Massachusetts, Mississippi, Missouri, Montana, Nebraska, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Utah, Vermont and Wisconsin. Ky. Dep't of Revenue, Income Tax Division, Circular 420005 (rev. Feb. 1, 1972).

<sup>47</sup> The credit is allowed to persons filing nonresident Kentucky returns if they are a resident of one of the following states: Arizona, California, District of Columbia, Idaho, Indiana, Maryland, Michigan, Minnesota, New Hampshire, New Mexico, Virginia and West Virginia. Ky. Dep't of Revenue, Income Tax Division, Circular 420005 (rev. Feb. 1, 1972). See Solomon, *Nonresident Personal Income Tax: A Comparative Study in Eight States*, 29 FORDHAM L. REV. 105 (1960).

<sup>48</sup> KRS § 141.070(2).

income is \$3,000 and total income taxed by the sister state is \$10,000, 30% of the income tax paid to the resident state is allowed as a credit for Kentucky tax purposes. This section further provides that no credit is allowed on income that is exempt from taxation under the laws of the state of residence.<sup>49</sup>

### III. INCOME SPLITTING

One of the most significant disparities between Kentucky law and federal law relates to treatment of the income of married couples where all or a large portion of their income is earned by only one spouse. In 1948 income splitting was adopted by Congress, permitting married couples to elect to file a joint return dividing their total taxable income equally between spouses.<sup>50</sup> A tax savings results because each half of the total taxable income thereby falls in a lower progressive rate bracket. The purpose of federal income splitting is to reconcile differences in taxation of married couples residing in common law states with those in community property states where property law automatically divides all income equally between spouses. It also eliminates the inequality in tax burden between families within a common law state where one spouse earns the entire income and families in which a part of the income is earned by each spouse.

In Kentucky, however, the need for revenue prevailed over the above-stated justification for federal income splitting and the policy of state conformity. A provision similar to federal income splitting, a fixture in the federal system for twenty-four years, has never been enacted. The resulting inequality in tax burden is best illustrated by an example. Consider spouses with incomes of \$6,000 each. The total state tax amounts to \$360 if computed on the basis of separate returns,<sup>51</sup> while a joint return (without income splitting) results in a tax of \$520.<sup>52</sup> Thus an equal income family unit of the same size with one spouse employed pays \$160

<sup>49</sup> *Id.*

<sup>50</sup> *Hearings of the House Comm. on Ways and Means, 80th Cong., 1st Sess. 846-74 (1947).*

<sup>51</sup> 2% on the first \$3,000 = \$60; 3% on the next \$1,000 = \$30; 4% on the next \$1,000 = \$40; 5% on the next \$1,000 = \$50. (( $\$60 + \$30 + \$40 + \$50$ )  $\times 2 = \$360$ ). KRS § 141.020(2).

<sup>52</sup> 2% on the first \$3,000 = \$60; 3% on the next \$1,000 = \$30; 4% on the next \$1,000 = \$40; 5% on the next \$3,000 = \$150; 6% on the last \$4,000 = \$240. ( $\$60 + \$30 + \$40 + \$150 + \$240 = \$520$ ). KRS § 141.020(2).

more in Kentucky income tax than the family in which both spouses work. This type of discrimination does not exist in the federal law because of the availability of income splitting. It is submitted that adoption of income splitting in Kentucky would mitigate the differences in tax liability between one and two job families, would contribute to equality among taxpayers, would provide simplification through closer conformity with federal law, and would therefore be a desirable move for Kentucky.

#### IV. RETURNS AND FILING REQUIREMENTS

Under present law married taxpayers have the option of filing either jointly (without income splitting) or separately if they are living together at the close of the taxable year.<sup>53</sup> If not living together they must file separately.<sup>54</sup> Under federal law in order to file a joint return the taxpayer need only be married on the last day of the taxable year.<sup>55</sup> Filing separately for Kentucky tax purposes does not necessarily mean that husband and wife must file two separate and distinct tax returns. Kentucky income tax regulations allow a husband and wife to file separately on one combined return if they are married at the close of the taxable year;<sup>56</sup> a column for each is provided on the return. Under this method the tax is computed separately but is assessed on an aggregate basis. If the combined return is elected, refunds are payable to husband and wife jointly and they are jointly and severally liable for any taxes, penalties and interest. The same would be true in the case of a joint return, like the federal.

Kentucky requires single persons and married persons living separately to file a return if their gross income is over \$1200 or their net income is over \$1000.<sup>57</sup> Married persons living together and persons who are blind, or over 65, or qualify as head of a household are not required to file unless gross income is \$2500 or

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<sup>53</sup> KRS § 141.180(2). A large number of Kentucky couples with separate incomes who file a joint federal return profit by filing separately for Kentucky in order to split the income into two lower individual rates. The Kentucky income tax rates and brackets are set forth in KRS § 141.020(2): 2% on the first \$3,000; 3% on the next \$1,000; 4% on the next \$1,000; 5% on the next \$3,000 and 6% on all income over \$8,000.

<sup>54</sup> *Id.* But see Ky. Income Tax Reg. II-2-2 (1972) which states: "A husband and wife may elect, for any year, to file a joint return if they are married at the close of the taxable year. . . ."

<sup>55</sup> IRC §§ 153, 6013.

<sup>56</sup> Ky. Income Tax Reg. II-2-2(c) (1972).

<sup>57</sup> KRS § 141.180(1); Ky. Income Tax Reg. II-3-1(a) (1972).



more or net income is \$2000 or more.<sup>58</sup> The federal law requires a return to be filed by an unmarried individual if gross income is \$2050 or more and by a married couple electing to file a joint return whenever their combined gross income is \$2800 or more.<sup>59</sup> The \$2050 and \$2800 limits are increased by \$750 for each additional dependency or personal exemption to which the taxpayer is entitled.<sup>60</sup> In many instances it will be necessary to file a Kentucky return when no federal return is required. This disparity was brought about by the introduction of the low income allowance and the increase in personal exemptions enacted as part of the Tax Reform Act of 1969 and raised by the Revenue Act of 1971. Under previous federal law, a return was required of every individual with gross income over \$600.

Both the federal and Kentucky law provide that returns must be filed by the fifteenth day of the fourth month following the close of the taxable year<sup>61</sup> and both laws allow reasonable extensions.<sup>62</sup> Under KRS § 141.170 a six month extension may be applied for by specific request, setting forth the reasons for the extension. It will be granted when in the judgment of the Department of Revenue good cause exists.<sup>63</sup> In addition, an automatic extension will be granted the Kentucky taxpayer for the same period of time for which the taxpayer has received a federal extension.<sup>64</sup> In either case a copy of the approved extension must accompany the return when ultimately filed.<sup>65</sup> KRS § 141.215 allows postponement of filing for servicemen on active duty until twelve months after termination of a national emergency or separation from service, whichever occurs first.<sup>66</sup>

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<sup>58</sup> *Id.* A nonresident will have met the conditions which require filing if total income from all states is greater than the minimum required for filing and the nonresident has received some Kentucky taxable income. Ky. Income Tax Reg. II-3-2 (1972).

<sup>59</sup> IRC § 6012(a)(1)(A).

<sup>60</sup> IRC § 6012(a)(1)(B).

<sup>61</sup> KRS § 141.160(1); Ky. Income Tax Reg. IG-5-1 (1972).

<sup>62</sup> KRS § 141.170; IRC § 6081(a).

<sup>63</sup> KRS § 141.170.

<sup>64</sup> Ky. Income Tax Reg. IG-5-2(b) (1972).

<sup>65</sup> Ky. Income Tax Reg. IG-5-2(a), (b) (1972).

<sup>66</sup> KRS § 141.215; Ky. Income Tax Reg. II-4-1 (1972).

Although the term "national emergency" is not defined . . . KRS 141.050(1) states that the Department of Revenue shall use the interpretations of the Federal Income Tax Law. Consequently, since the Federal law postpones the filing of federal returns while an active service member is in a combat zone, the designation of a combat zone by presidential

(Continued on next page)

## V. PERSONAL TAX CREDITS

The theory behind a personal exemption allowance is to leave untaxed a minimum of subsistence so that every person has enough funds to support his family according to an accepted standard of living.<sup>67</sup> The federal law currently allows a personal and dependency exemption of \$750 for each individual to be deducted in arriving at taxable income.<sup>68</sup> Instead of an exemption Kentucky currently permits a tax credit amounting to \$20 for each taxpayer and dependent, to be subtracted directly from the tax.<sup>69</sup> The reduction in tax resulting from the allowance of an exemption of income subject to tax varies depending on the individual's tax bracket. Thus, the credit is more consistent with the underlying theory of the personal tax allowance because it gives equal advantage to each individual.<sup>70</sup>

As the federal law allows exemptions, the Kentucky law allows a credit for each taxpayer and dependent, as well as additional credits for taxpayers who are blind or over 65 years of age.<sup>71</sup> The requirements which must be satisfied in order to claim a credit for Kentucky tax purposes in each of the above instances are essentially identical to the federal requirements for allowance of exemptions.<sup>72</sup> The only federal provision not appearing in

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(Footnote continued from preceding page)

proclamation for federal purposes has the effect of identifying a national emergency and activates KRS 141.215. Proclamation 11216, dated April 24, 1965, established a combat zone in Vietnam, effective Jan. 1, 1965. Letter from Ky. Dep't of Revenue, Feb. 17, 1967. 1 CCH STATE TAX REP., KY. ¶ 13,337 (1971).

<sup>67</sup> Other arguments advanced in favor of a personal untaxed allowance are: (1) individuals below a certain income level have no ability to pay taxes; (2) consumption taxes fall more heavily on low income groups and consequently they should get some relief from the income tax; and (3) the potential revenue to be derived from a tax levied at these low income levels is too insignificant to justify the added administrative costs. KENTUCKY LEGISLATIVE RESEARCH COMMISSION, THE INDIVIDUAL INCOME TAX; PRELIMINARY DRAFT 17-18 (1955).

<sup>68</sup> IRC § 151.

<sup>69</sup> KRS § 141.020(3); *cf.* Reynolds Metal Co. v. Martin, 107 S.W.2d 251, 263 (1937), where the Kentucky Court of Appeals wrote that the state system "works for greater fairness and equality than does the federal act."

<sup>70</sup> See note 67 *supra*.

<sup>71</sup> KRS § 141.020(3).

<sup>72</sup> The federal provisions relating to allowance of personal exemptions are contained in IRC §§ 151-53. KRS § 141.010(4) incorporates by reference the provisions of IRC §§ 151(e) and 152 relating to dependency exemptions. KRS § 141.020(3)(b) incorporates by reference IRC § 153 relating to the determination of marital status. IRC § 151(a), (b), (c) and (d)(1) and (d)(2) are not incorporated for Kentucky tax purposes because these provisions relate specifically to exemptions which are inapplicable under the credit system of the Kentucky law. The only provision not included in the Kentucky statute which should be included is IRC § 151(d)(3) which defines blindness.

the Kentucky statute is the definition of blindness. The Kentucky statute presently allows an additional credit to the blind taxpayer without defining the degree of blindness necessary to claim it. Although a Kentucky Income Tax Regulation provides that "a \$20 tax credit is permitted for each personal exemption that is allowed in computing Federal taxable income,"<sup>73</sup> and would encompass the federal definition of blindness, no statutory authority for the blindness definition exists. It is submitted that inclusion of the federal definition of blindness contained in *Internal Revenue Code* § 151(d)(3) [hereinafter cited as IRC] should be included in the Kentucky law in order to safely complete the statutory scheme.

#### VI. DIVISION AND PRORATION OF TAX CREDITS

In the case of taxpayers resident in Kentucky during the entire year the only limitation on division of tax credits is that married taxpayers must claim their own credits if separate returns are filed.<sup>74</sup> They may divide the tax credits of dependents in any manner they elect. The full credit is not allowed to nonresident and part year resident taxpayers. These persons may deduct only that proportionate part of any credits to which they are otherwise entitled (determined by the ratio of Kentucky adjusted gross income, exclusive of federal income tax deductions and refunds, to federal adjusted gross income).<sup>75</sup> A married nonresident taxpayer whose spouse has no Kentucky income has the option of claiming only the proportionate part of his individual credit, or in addition, the credits for his spouse and dependents.<sup>76</sup> However, if the latter is chosen the denominator of the fraction must include the total income of both spouses.

#### VII. GROSS INCOME

Because Kentucky law adopts the definition of gross income in the *Internal Revenue Code*, most income exempt from the federal

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<sup>73</sup> Ky. Income Tax Reg. II-7-1 (1972).

<sup>74</sup> Ky. Income Tax Reg. II-7-4 (1972). The same is true with respect to nonresidents. See Ky. Income Tax Reg. II-7-3(a) (1972).

<sup>75</sup> KRS § 141.020(3)(h), (i); Ky. Income Tax Reg. II-7-2, 3 (1972). For new residents this computation is made on Ky. Dep't of Revenue, Schedule T-1, Tax Computation for New Residents. For nonresidents the computation is made on Ky. Dep't of Revenue Form 740-N, Kentucky Nonresident Income Tax Return.

<sup>76</sup> KRS § 141.020(3)(h); Ky. Income Tax Reg. II-7-3(b).

tax is likewise exempt from Kentucky tax<sup>77</sup> and most income taxed by federal law is also taxed by Kentucky.<sup>78</sup> There are, however, several important points of difference set out in KRS § 141.010(9)(a)-(f). The first of these provides for exclusion of income for state tax purposes "that is exempt from state taxation by the *Kentucky Constitution* and the *Constitution* and *statutory laws* of the United States" (emphasis added).<sup>79</sup>

### A. *State Constitutional and Statutory Restrictions*

Section 171 of the Kentucky Constitution exempts bonds of the Commonwealth, counties, municipalities, and school districts from any type of state taxation.<sup>80</sup> Thus interest income from such bonds is constitutionally exempt. Statutory exemptions following this constitutional mandate include interest on county and regional housing commission bonds.<sup>81</sup> Although not provided for specifically in the statute, the constitutional provision also guarantees an exemption for bonds issued by a city under KRS §§ 103.200-103.285 to purchase an industrial building for use by a manufacturer<sup>82</sup> and for bonds issued by the Kentucky Authority for Educational Television.<sup>83</sup>

KRS § 141.010(9)(d) provides for the exclusion of "income

<sup>77</sup> For federal exclusions from gross income applicable to Kentucky, *see* IRC § 101 (death benefits); § 102 (gifts and inheritances); §§ 104, 105 and 106 (concerning exclusions related to sickness and health insurance); § 107 (rental value of parsonages); § 108 (discharge of indebtedness); §§ 109, 110 (lessee improvements and tax payments); § 111 (recovery of bad debts, etc.); § 112 (combat pay); § 113 (mustering out pay); § 114 (Red Cross sports program); § 115 (income of states, municipalities, etc.); § 117 (scholarships); § 118 (contributions to capital); § 119 (meals and lodging); § 121 (sale of personal residence after age 65); § 122 (certain retirement pay); § 123 (certain living expenses); § 124 (cross references). KRS § 141.010(9) incorporates these provisions by reference.

<sup>78</sup> IRC § 61. "Except as otherwise provided in this subtitle [*see note 77 supra*] gross income means all income from whatever source derived. . . ." For items specifically included in gross income *see* § 71 (alimony); § 72 (certain insurance and annuity payments); § 73 (services of child); § 74 (prizes); § 75 (dealers in tax exempt securities); § 76 (obligations of joint stock land banks); § 77 (commodity credit loans); § 79 (group term life insurance); § 80 (restoration of value of certain securities); § 81 (suspense accounts); § 82 (reimbursed moving expenses); § 83 (property transferred in connection with performance of services). KRS § 141.010(9) incorporates these provisions by reference.

<sup>79</sup> KRS § 141.010(9)(a).

<sup>80</sup> KY. CONST. § 171. "Bonds of the state and of counties, municipalities, taxing and school districts shall not be subject to taxation."

<sup>81</sup> KRS § 80.560.

<sup>82</sup> KY. OP. ATT'Y GEN. No. 63-398, May 3, 1963.

<sup>83</sup> KY. OP. ATT'Y GEN. No. 62-578, August 24, 1962. *See* KY. OP. ATT'Y GEN. No. 62-814, Sept. 12, 1962, providing that where a county transferred its courthouse to a nonprofit corporation which issued bonds, improved the courthouse, and leased it back to the county, the interest on such bonds is exempt.

from supplemental annuities provided by the Railroad Retirement Act of 1937 as amended and which are subject to the federal income tax by Public Law 89-699.” Another state statutory retirement exclusion which was enacted in the 1972 session of the General Assembly is KRS § 141.021 which provides that, notwithstanding the provisions of KRS § 141.010, military and civil service retirement annuities received by persons who have attained the age of 65 are exempt from Kentucky income tax in an amount determined on a scale which decreases the maximum \$4000 exclusion as earned income from other sources increases.<sup>84</sup> Kentucky statutory limitations on gross income not found in the KRS Chapter on Revenue and Taxation include Kentucky retirement income of state and county employees, teachers, and the judiciary, which are specifically exempted from Kentucky Income Tax by the statutes establishing the retirement systems.<sup>85</sup> Although no authority is found for these *statutory* exemptions in the definition of gross income in KRS § 141.010(9), it appears that since the legislature has the power to amend the taxing statute to exempt these items it impliedly did so when it passed the specific statutes.

**B. Federal Constitutional and Statutory Restrictions**

The most viable federal constitutional prohibitions on state income taxing power include the commerce clause,<sup>86</sup> contracts clause,<sup>87</sup> privileges and immunities clause,<sup>88</sup> due process and

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<sup>84</sup> If Earned Income from Other Sources is:	The Maximum Retirement Exclusion is:
\$3000 or less .....	\$4000
\$3001 to \$4000 .....	\$3000
\$4001 to \$5000 .....	\$2000
\$5001 to \$6000 .....	\$1000
Over \$6000 .....	\$-0-

For the applicable definition of earned income, *see* IRC § 911(b), which essentially defines the term as “wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered.” KRS § 141.021; Ky. Income Tax Reg. II-8 (1972). These provisions became effective for taxable years beginning after December 31, 1971.

<sup>85</sup> Ky. Income Tax Reg. II-8-1 (1972). *See also* Ky. Acrs ch. 15, § 15 (1960), authorizing the payment of a veterans’ bonus and providing an exemption from all types of taxation by the state. In *Stovall v. Gartrell*, 332 S.W.2d 256 (Ky. 1960), the Court of Appeals upheld this exemption.

<sup>86</sup> U.S. CONSR. art. I, § 8. *See Note, Multi-State Taxation of Personal Income*, 111 U. PA. L. REV. 974 (1963).

<sup>87</sup> U.S. CONSR. art. I, § 10. *See Hale v. Iowa State Bd. of Assessment & Review*, 302 U.S. 95 (1937).

<sup>88</sup> U.S. CONSR. art. IV, § 2. *See Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920), holding that a state may not deny personal exemptions to nonresidents which are granted residents even if other benefits are granted nonresidents and not residents.

equal protection clauses<sup>89</sup> and the implied doctrine of intergovernmental tax immunities. The latter doctrine was first enunciated in *McCulloch v. Maryland*<sup>90</sup> where the Supreme Court stated that "the power to tax is the power to destroy" and held that the supremacy clause of Article IV of the United States Constitution prohibited a discriminatory tax on national bank notes. In addition to the supremacy argument the Court stressed the fact that it interfered with the *means* employed by the federal government in carrying out its constitutional powers. This reasoning later served as the basis for the doctrine of reciprocal intergovernmental immunity.<sup>91</sup> In *Weston v. City Council of Charleston*,<sup>92</sup> the Court, following *McCulloch*, held that the states may not impair the power of the federal government to borrow money by imposing a tax on federal obligations. In *Collector v. Day*,<sup>93</sup> the intergovernmental immunity doctrine was extended to federal taxes on state instrumentalities. The Court reasoned that:

[I]f the means and instrumentalities employed by [the federal] government to carry into operation the powers granted it are, necessarily, and, for the sake of self-preservation, exempt from taxation by the States, why are not those of the States depending on their reserved powers, for like reasons, equally exempt from federal taxation? Their unimpaired existence in the one case is as essential as in the other.<sup>94</sup>

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<sup>89</sup> U.S. CONST. amend. XIV, § 1. The due process clause has been held to require some definite link, some minimum connection, between a state and the person, property or transaction taxed. *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940). For a provision held invalid as violative of equal protection, see *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920).

<sup>90</sup> 17 U.S. (4 Wheat.) 316 (1819).

<sup>91</sup> Comment, *Tax-Exempt State and Local Bonds: Form of Intergovernmental Immunity and Form of Intergovernmental Obligation*, 21 DE PAUL L. REV. 757, 763 (1972).

<sup>92</sup> 27 U.S. (2 Pet.) 449 (1829).

<sup>93</sup> 78 U.S. (11 Wall.) 113 (1870).

<sup>94</sup> *Id.* at 127. For more extensive articles dealing with the subject of intergovernmental immunities see Comment, *Tax-Exempt State and Local Bonds: Form of Intergovernmental Immunity and Form of Intergovernmental Obligation*, 21 DE PAUL L. REV. 757 (1972); Comment, *The Taxability of State and Local Bond Interest by the Federal Government*, 38 U. CIN. L. REV. 703 (1969); Comment, *Intergovernmental Tax Immunities: An Analysis and Suggested Approach to the Doctrine and its Application to State and Municipal Bond Interest*, 15 VILL. L. REV. 414 (1970); Lent, *The Origin and Survival of Tax-Exempt Securities*, 12 NAT'L TAX J. 301 (1959); Note, *Federal Immunity from State Taxation*, 68 DICK. L. REV. 469 (1964); Ratchford, *Intergovernmental Tax Immunities in the United States*, 6 NAT'L TAX J. 305 (1935).

The doctrine of full intergovernmental tax immunity originally prohibited federal taxation of state instrumentalities and state taxation of federal instrumentalities. Later constitutional decisions restricted the scope of the doctrine to income from governmental obligations.<sup>95</sup> The doctrine has also been contracted by congressional consent to taxation of income earned in federal areas,<sup>96</sup> compensation of officers and employees of the United States<sup>97</sup> and, to a limited extent, income from national banks.<sup>98</sup>

### C. *Income from Obligations of Sister States*

Section 103 of the *Internal Revenue Code* provides that "gross income does not include interest on . . . the obligations of a state . . . or any political subdivision" thereof. KRS § 141.010(9) states that "gross income" for Kentucky income tax purposes is equivalent to "gross income" as defined by § 61 of the *Internal Revenue Code* except for specific enumerated differences. One of these adjustments is found in KRS § 141.010(9)(e) which provides that gross income shall "include interest income derived from obligations of sister states and political subdivisions thereof." The effect of this provision, when read in conjunction with IRC § 103, is to tax interest income from the obligations of sister states and to exclude interest income from Kentucky obligations, which is guaranteed by § 171 of the Kentucky Constitution. The apparent purpose of taxing obligations of sister states is to make Commonwealth bonds more attractive to Kentucky investors.

### D. *Kentucky Bank Dividend Income*

Another variation from federal gross income is found in KRS § 141.010(9)(b) which provides for the exclusion of "dividend income received from stock of banks and trust companies<sup>99</sup> organized under the laws of this state." The rationale underlying this provision stems from the combined effect of a federal

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<sup>95</sup> *New York v. United States*, 326 U.S. 572 (1946); *Helvering v. Gerhardt*, 304 U.S. 405 (1938); *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939). See also 31 U.S.C. § 742 (1970) which forbids state taxation of United States obligations. KY. OP. ATT'Y GEN., June 13, 1939, provides that interest received from any securities which are obligations of the United States is not taxable.

<sup>96</sup> Buck Act, 4 U.S.C. § 106 (Supp. 1972).

<sup>97</sup> Public Salary Act of 1939, 4 U.S.C. § 111 (Supp. 1972).

<sup>98</sup> 12 U.S.C. § 548 (Supp. 1972), amending 12 U.S.C. § 548 (1970).

<sup>99</sup> See KY. OP. ATT'Y GEN., Oct. 1, 1941, declaring that dividends paid to stockholders of building and loan associations are not exempt from Kentucky income tax.

statutory limitation and a requirement in § 172 of the Kentucky Constitution. Under the federal statute each state must choose one of four alternative methods of taxing national banks.<sup>100</sup> Since § 172 of the Kentucky Constitution provides for taxation of all property not otherwise "exempted from taxation by this Constitution,"<sup>101</sup> it appears that Kentucky is constitutionally required to levy a capital stock tax on national banks. Therefore, since the federal statute allows only one type of tax and Kentucky must levy a capital stock tax, it is thereby precluded from levying an income tax on dividends from national bank shares.<sup>102</sup> Consequently KRS § 141.010(9)(b) is apparently intended to prevent state banks from being taxed more heavily than national banks.<sup>103</sup> Although the exemption of Kentucky bank stock dividends from state income taxation does not hinge upon statutory or constitutional grounds, it appears to be based upon desirable policy. It keeps holders of national bank stocks from enjoying a tax advantage not enjoyed by the holders of Kentucky bank stocks, thereby preventing a competitive advantage to national banks by making their shares more attractive to investors than state bank shares.<sup>104</sup>

#### E. *Undistributed Income of Subchapter S Corporations*

Under federal law corporations with ten or fewer shareholders which satisfy certain other requirements may elect to be taxed in a manner similar to partnerships.<sup>105</sup> Thus, instead of the corporation paying a tax, the shareholders of a Subchapter S Corporation individually pay taxes on their proportionate part of the undistributed income of the corporation. The purpose of this "conduit" treatment is to allow small businesses to avail themselves of the advantages of the corporate form of doing business without incurring a tax greater than if they operated as a partnership. This provision is not followed by Kentucky. Consequently, in reconciling the differences between Kentucky and federal gross income, KRS § 141.010(9)(c) provides for the exclusion of the undistributed income of a Subchapter S Corporation.

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<sup>100</sup> 12 U.S.C. § 548 (Supp. 1972), *amending* 12 U.S.C. § 548 (1970).

<sup>101</sup> *Cf.* Land v. Kentucky Joint Stock Land Bank, 131 S.W.2d 838 (Ky. 1939).

<sup>102</sup> R. Jewert, *supra* note 18, at 84.

<sup>103</sup> *Id.*

<sup>104</sup> *Cf.* Reynolds Metal Co. v. Martin, 107 S.W.2d 251, 261, 264 (Ky. 1937).

<sup>105</sup> *See* IRC §§ 1371-77.



Kentucky, by denying recognition of the Subchapter S election for tax purposes, has reduced the benefits of the election for federal tax purposes.<sup>106</sup> Before repeal of the federal corporation tax deduction by the 1972 General Assembly the state tax rate on Subchapter S Corporations was doubled because the Subchapter S Corporation had no federal tax to deduct. Furthermore the federal tax paid at the individual level on the undistributed portion of the Subchapter S income was not deductible because it was not taxed by Kentucky.<sup>107</sup> Repeal of the federal corporate tax deduction has eliminated the problem of doubling the tax rate but the loss by Subchapter S shareholders of their federal tax deduction at the individual level remains.

The Subchapter S provisions were first introduced into the federal law in 1958. In the 1960 and 1962 sessions of the Kentucky General Assembly, bills were introduced which would have recognized the Subchapter S election for Kentucky income tax purposes.<sup>108</sup> Both bills were defeated because it was thought that the law would be difficult to administer for shareholders residing outside the Commonwealth and as a result would entail a substantial loss of revenue.<sup>109</sup> The chief concern was to prevent out-of-state shareholders from escaping Kentucky taxation. It is suggested that Kentucky should allow the Subchapter S election to all corporations. The greatest benefit would go to Kentucky residents because corporations which elect Subchapter S taxation are generally small local enterprises. With respect to nonresident shareholders the law could merely require the posting of a bond in order to insure the payment of tax.

#### F. *Corporate Dividends Exclusion*

Although federal law allows an individual exclusion of up to \$100 of stock dividends,<sup>110</sup> Kentucky does not recognize such a provision.<sup>111</sup> The purpose of the federal exclusion represents an attempt to extend relief from "double taxation" and to encourage stock ownership among lower bracket taxpayers. The 1956

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<sup>106</sup> See Stine, *Subchapter S election may increase state income tax on corporations or stockholders*, 10 J. TAXATION 91 (1959); Kalupa, *Subchapter S election may cause increase in state taxes*, 10 J. TAXATION 137 (1959).

<sup>107</sup> KRS § 141.010(10).

<sup>108</sup> R. Jewert, *supra* note 18, at 90.

<sup>109</sup> *Id.*

<sup>110</sup> IRC § 116.

<sup>111</sup> KRS § 141.010(9)(f).

General Assembly declined to incorporate this exclusion into Kentucky law,<sup>112</sup> and therefore apparently found fault with the policies it was designed to promote or did not wish to suffer the resultant loss of revenue. However, considering the small amounts involved, it may be desirable in the interest of simplicity for Kentucky to conform to federal law in this respect. In addition, abolition of the federal tax deduction discussed below would more than adequately make up for any revenue loss.

### VIII. ADJUSTED GROSS INCOME

#### A. Introduction

KRS § 141.010(10) defines the term "adjusted gross income" as gross income "minus the deductions allowed individuals by § 62 of the *Internal Revenue Code*." Section 62 allows deductions for trade or business expenses, 50% of long term capital gains, losses from the sale or exchange of business property, expenses attributable to rents and royalties, moving expenses, certain pension plans and certain expenses of income beneficiaries of property held in trust. KRS § 141.010(11) further provides as an overall restriction that these deductions "shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter." Presumably, this phrase is included to make clear that no deduction is allowed for expenses incurred to earn income which is not taxed by Kentucky.<sup>113</sup>

#### B. Percentage Limitation on Certain Deductions

The concept of adjusted gross income is significant because it serves as a base to be used in computing the amount of certain deductions.<sup>114</sup> KRS § 141.010(11) incorporates many deductions which are allowed under the *Internal Revenue Code* for Kentucky tax purposes. One of these is § 213 which provides for the deduction of medical expenses that exceed 3% of adjusted gross income. Thus the smaller the taxpayer's adjusted gross income, the smaller the limitation, and hence the larger the deduction. KRS § 141.010(10) allows the deduction of federal income taxes in computing adjusted gross income for Kentucky tax purposes.

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<sup>112</sup> Ky. Acts ch. 4 (1956).

<sup>113</sup> Cf. IRC § 265 which provides that no deduction shall be allowed for expenses and interest relating to tax exempt income.

<sup>114</sup> See IRC § 213 (medical expenses), § 170 (charitable contributions) and § 214 (child care expenses).

Therefore, federal income taxes should be deducted in order to determine adjusted gross income for purposes of computing the 3% limitation. However, the Department of Revenue, in designing the Kentucky income tax form, has provided that the 3% limitation be based on Line 11 of the Kentucky Individual Income Tax Return.<sup>115</sup> Line 11 reflects all deductions allowed in arriving at adjusted gross income except the deduction for federal income taxes.<sup>116</sup> Consequently, it appears that the computation of the 3% limitation should have been based on Line 13 which reflects the deduction of federal income taxes and is thus consistent with the definition of "adjusted gross income" in KRS § 141.010(10).<sup>117</sup> In light of KRS § 141.010(10) it seems that there is statutory authority for Kentucky taxpayers to base computation of the 3% medical expense limitation<sup>118</sup> on adjusted gross income as determined after deduction of federal income taxes.<sup>119</sup>

### C. *Federal Income Tax Deduction*

Kentucky follows the federal definition of adjusted gross income with one significant exception. KRS § 141.010(10) provides for the deduction of federal income tax in arriving at Kentucky adjusted gross income. However, the deduction is only allowed with respect to federal income tax paid upon income taxed by Kentucky. Thus, an individual moving into Kentucky during the taxable year is entitled to deduct only the federal tax paid upon income earned in and taxed by Kentucky. Similarly, no deduction is allowed for federal tax paid on income subject to the federal tax which is exempt from Kentucky tax.<sup>120</sup>

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<sup>115</sup> See Kentucky Individual Income Tax Return, Ky. Dep't of Revenue Form 740, Line 11 (1972), and Kentucky Individual Income Tax Return, Ky. Dep't of Revenue Form 740, Schedule A, Line 7 (1972).

<sup>116</sup> See Kentucky Individual Income Tax Return, Ky. Dep't of Revenue Form 740, Lines 11, 12 and 13 (1972).

<sup>117</sup> The same is true regarding the charitable contributions deduction. See IRC § 170 and Ky. Dep't of Revenue, Instructions for Preparing 1972 Kentucky Individual Income Tax Returns, Contributions 6-7 (1972). However, in this instance, the mistake operates in favor of the taxpayer by allowing him a higher contribution base and hence, when the percentage limitation is applied, a larger deduction.

<sup>118</sup> The same is true of the percentage limitations on medicine and drugs. See IRC § 213 and Kentucky Individual Income Tax Return, Ky. Dep't of Revenue Form 740, Schedule A, Line 3 (1972).

<sup>119</sup> See Ky. Dep't of Revenue, Kentucky Individual Income Tax Return Form 740, Schedule A, Line 7 (1972); Ky. Dep't of Revenue, Instructions for Preparing 1972 Kentucky Individual Income Tax Returns, Medical and Dental Expenses 6 (1972).

<sup>120</sup> KRS § 141.010(8); Ky. Income Tax Reg. II-9-2 (1972).

The taxpayer must elect between the cash or accrual method of deducting federal income tax on his initial return. Either method may be chosen regardless of the accounting method used for other purposes, and, once an election is made, written permission of the Department of Revenue is required to change.<sup>121</sup> If the cash method is elected the taxpayer is entitled to deduct for the current year all federal tax (1) withheld, (2) paid by declaration, (3) paid for the prior year and (4) paid for any previous year.<sup>122</sup> The accrual method entitles the taxpayer to a deduction in the amount of the federal tax liability shown on the return for the year it applies regardless of when paid.<sup>123</sup>

#### D. Federal Tax Refunds

KRS § 141.010(10) also differs from federal adjusted gross income by providing that Kentucky adjusted gross income shall "include all overpayments of federal tax refunded or credited to the taxpayer during the taxable year."<sup>124</sup> This provision is based on the "tax benefit rule,"<sup>125</sup> and, although not mentioned in the statute, assumes that the taxpayer receives a "tax benefit" from the previous year's federal tax deduction. If there was no tax benefit from the prior deduction the refund received in the current year does not have to be included. There will be no tax benefit if the taxpayer's other allowable deductions are sufficient to result in no tax or if he fails to take advantage of the federal tax deduction; in these situations the taxpayer is not required to include the refund when computing Kentucky adjusted gross income. Another example is a taxpayer who moves to Kentucky during the current year and is filing a Kentucky return for the first time. He should not be required to include his federal refund in Kentucky adjusted gross income; no tax benefit was received since there was no prior deduction.

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<sup>121</sup> Ky. Income Tax Reg. II-9-5 (1972).

<sup>122</sup> Ky. Income Tax Reg. II-9-3 (1972). Ky. Income Tax Reg. II-9-6 (1972) provides that "additional tax resulting from federal audits of prior returns may be deducted [only] if the adjustments creating the additional federal income tax were taxed by Kentucky or results in additional Kentucky income tax."

<sup>123</sup> Ky. Income Tax Reg. II-9-4 (1972).

<sup>124</sup> See Ky. Income Tax Reg. II-9-7 (1972).

<sup>125</sup> In essence, the tax benefit rule provides that to the extent a taxpayer reduces his income tax in a prior year as a result of a deduction, all or part of which he subsequently recovers, he must include such amount in income in the year recovered.

## IX. ABOLITION OF THE FEDERAL TAX DEDUCTION

There are several cogent arguments in favor of abolishing the deduction of federal income taxes.<sup>126</sup> First, abolition of the federal tax deduction could make possible a reduction in rates with no loss of revenue. Kentucky's tax climate would appear more favorable in comparison with other states.<sup>127</sup>

Second, under the existing situation, when Congress increases or decreases the federal income tax, either through changes in rates or deductions, the state income tax yield is increased or decreased inversely. This could have serious consequences in terms of budgeting and estimated revenue yield, especially if the next legislative session is months away.<sup>128</sup>

Third, on the ground of simplicity, repeal of the federal tax deduction would eliminate the process of adding the federal refund received and deducting the federal tax paid in computing Kentucky adjusted gross income.<sup>129</sup>

Fourth, and of great importance, the federal income tax deduction, because of the steeply progressive federal tax rates, distorts the progressive element of the Kentucky tax. A person in the top federal tax bracket saves more in Kentucky income tax than the lower bracket taxpayer. Thus an individual subject to a top federal marginal rate of 70%, who, in the absence of the federal tax deduction would pay Kentucky tax at the top rate of 6%, pays tax to the Commonwealth at an effective marginal rate of only 1.8%. This is because after paying a federal tax of \$700 on \$1000 of income and deducting the \$700 federal tax paid on the Kentucky tax return, the resulting tax base for Kentucky is only \$300. Six percent of \$300 equals \$18 tax paid to Kentucky on \$1000 of income. Six percent of \$1000 would have been \$60. The reduction in income tax paid to Kentucky because of the federal tax deduction is \$42.<sup>130</sup> Further, the federal income tax deduction is of comparatively slight significance to individuals in Kentucky's lowest 2% rate bracket. Thus, a single individual

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<sup>126</sup> The federal income tax deduction for corporations was repealed by the 1972 General Assembly. Ky. Acts ch. 62, § 3(6)(c) (1972).

<sup>127</sup> D. SOULE & S. LILE, SOME PROBLEMS OF EQUITY AND ADEQUACY IN KENTUCKY'S STATE-LOCAL TAXATION 26 (1970).

<sup>128</sup> *Id.*

<sup>129</sup> See KRS § 141.010(10).

<sup>130</sup> L. FREIBERG & D. SOULE, KENTUCKY TAX POLICY: SUGGESTED CONSIDERATIONS (Ky. Leg. Res. Comm'n Res. Rep. No. 69, 1972).

earning \$3000 in 1972 will save only \$2.82 (2% x \$141 of federal tax) as a result of the federal tax deduction, while a taxpayer subject to the top marginal rate of 70% will save \$126 in state taxes (6% x \$2100 of federal tax). The following table illustrates the overall effective Kentucky tax rate at selected income levels with and without the federal income tax deduction:

TABLE No. 1  
IMPACT OF THE FEDERAL TAX DEDUCTION  
ON OVERALL EFFECTIVE KENTUCKY TAX RATES<sup>131</sup>

Income	Federal Tax Deducted	Federal Tax Not Deducted
\$ 3,500	-0-	-0-
5,000	0.4	0.6
7,500	1.5	2.0
10,000	2.2	2.9
17,500	2.8	3.5
25,000	3.2	4.1
50,000	3.1	4.5
100,000	2.8	5.0

Notice that when income reaches \$50,000 the overall effective Kentucky tax rate actually begins to decrease when the federal tax deduction is allowed. On the other hand, when the federal tax deduction is not allowed some measure of progressivity is restored.

Elimination of the federal tax deduction would contribute to the overall fairness of Kentucky's tax structure. State income taxes are intended to reach income from types of property which is otherwise taxed lightly, such as intangible personal property, *i.e.*, stocks, bonds and mortgages. A progressive income tax would tend to offset this advantage for the wealthy who own more of this property than lower income taxpayers.<sup>132</sup> The same is true with respect to the Kentucky sales tax which is the single most important state revenue producer (38%).<sup>133</sup> The sales tax is regressive, *i.e.*, it bears more heavily on lower income taxpayers who spend proportionately larger amounts of income for consumption. It does not reach savings and expenditures for services, both of which tend to increase as income rises.<sup>134</sup> A more pro-

<sup>131</sup> Data taken from D. SOULE & S. LILE, *supra* note 127, at 25.

<sup>132</sup> *Id.* at 26.

<sup>133</sup> KY. DEPT OF REVENUE, ANNUAL REPORT 1970-1971, at 9.

<sup>134</sup> D. SOULE & S. LILE, *supra* note 127, at 26.

gressive state income tax, achieved through elimination of the federal tax deduction (which would be more politically acceptable than a rate increase), would tend to distribute the overall tax burden more evenly.

It has been estimated that revenues from the Kentucky income tax would increase by over 40 million dollars in the absence of a federal tax deduction.<sup>135</sup> As mentioned above, an indirect income tax increase through elimination of a deduction would be more likely to pass in the legislature than a direct rate increase. Kentucky could use this opportunity to effect an adjustment in the Commonwealth's tax structure with no overall loss, or perhaps an increase, in revenue. Depending on its choice of policy, Kentucky could use the increased revenue from elimination of the deduction in several ways: (1) lower or repeal some other type of tax or taxes, *e.g.*, lower the sales tax or repeal some federally nondeductible taxes; (2) decrease Kentucky income tax rates; (3) restructure Kentucky rate brackets to make the Kentucky personal tax bear less heavily on lower and middle income taxpayers who assume a proportionately greater burden of the sales tax, *viz.* 2% on the first \$5000, 3% on the next \$2000, 4% on the next \$2,000, 5% on the next \$2000 and 6% on the excess above \$11,000;<sup>136</sup> (4) conform the Kentucky personal income tax more closely to federal law; or (5) any combination of the above.

Another facet of the argument to eliminate the federal tax deduction stems from the allowance of all state income taxes as a federal income tax deduction. Thus, as a result of the federal tax deduction, taxpayers in the 70% federal bracket pay substantially less in state tax than they otherwise would. In the absence of a federal tax deduction a 70% bracket taxpayer would pay \$6 state tax on each \$100 of income. However, since the \$6 would become a deduction on his federal return (which is \$4.12 more state tax than he would pay if the federal tax deduction were allowed), the taxpayer would save \$2.88 in federal tax ( $70\% \times \$4.12$ ) and his total additional tax burden would be only \$1.24 while state revenue would increase by \$4.12. This is illustrated by the following table for taxpayers in the 50% and 70% federal brackets:

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<sup>135</sup> L. FREIBERG & D. SOULE, *supra* note 130, at 63.

<sup>136</sup> Compare existing Kentucky income tax rates found in KRS § 141.020(2).

TABLE NO. 2  
TAX ON \$100 OF ADDITIONAL INCOME<sup>137</sup>

	Federal Tax Deducted	Federal Tax Not Deducted
70% Federal Tax	68.68	65.80
6% State Tax	1.88	6.00
Total Tax	<u>70.56</u>	<u>71.80</u>
50% Federal Tax	48.45	47.00
6% State Tax	3.09	6.00
Total Tax	<u>51.54</u>	<u>53.00</u>

Elimination of the federal tax deduction would seem to be a desirable alternative for Kentucky to follow. It would achieve simplicity, predictability of revenue, and would restore some measure of progressivity to the Kentucky Income Tax. Not only would state revenue be increased but part of the increase would also be financed by dollars now flowing to the federal government.<sup>138</sup> As a result of the increase, Kentucky would be in a position to reduce charges for services which now take the form of nondeductible expenditures *e.g.*, the \$12.50 Kentucky car license fee or to adjust the revenue structure in other ways.

One of the most desirable ways to use some of the additional revenue from eliminating the federal deduction would be to conform Kentucky's income tax more closely with the federal law. There are existing differences which achieve no state policy except to fulfill revenue needs. By using just a small portion of the potential revenue gained by abolishing the federal tax deduction, several differences could be eliminated, thereby reducing the task of the Kentucky Department of Revenue and simplifying compliance for the Kentucky taxpayer.

## X. NET INCOME

### A. *Itemized Deductions*

As with the federal income tax, Kentucky taxpayers have the option of itemizing their personal non-business deductions (and those business deductions which are not allowed in computing adjusted gross income) or, in lieu thereof, electing to take the \$500 standard deduction.<sup>139</sup> The itemized deductions allowed for

<sup>137</sup> Data taken from L. FREIBERG & D. SOULE, *supra* note 130, at 61 n.3.

<sup>138</sup> Moscovitch, *State Graduated Income Taxes—A State-Initiated Form of Federal Revenue Sharing*, 25 NAT'L TAX J. 53 (1972).

<sup>139</sup> KRS § 141.010(11).



Kentucky tax purposes are, with several exceptions, "the deductions allowed individuals by Chapter 1 of the Internal Revenue Code."<sup>140</sup> An important exception, where Kentucky's concern with revenue needs seems to have prevailed over the policy of equity for taxpayers, is the disallowance of the net operating loss deduction found in § 172 of the *Internal Revenue Code*.<sup>141</sup>

In essence, IRC § 172 allows a taxpayer who incurs business losses substantially in excess of income in any single year to spread them over a number of years and apply them against his taxable income earned in those years. By denying this deduction, Kentucky is discriminating against individual businessmen or farmers who suffer losses greatly in excess of income in a single year and who without the carryover or carryback, lose their deduction forever. By comparison, taxpayers who suffer a series of smaller losses less than each year's income are allowed to offset these losses against taxable income in the current year. The result is that the taxpayer who suffers the large loss is taxed more heavily on the same amount of overall income. He thus finds himself paying Kentucky income tax on income from a business in a year subsequent to large losses, even though the overall operation of the business remains a substantial loss. It appears only fair that success or failure of the overall business operation should be determinative on the question of whether an income tax is due; if the venture results in a loss over a long term, there is in a very real sense no income to be taxed. In the interest of equal treatment of taxpayers with equal amounts of income, tax simplicity as a result of closer conformity with the federal law, and encouragement of new business which may incur large losses in their

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<sup>140</sup> The itemized deductions allowed individuals by Chapter 1 of the Internal Revenue Code are those listed at §§ 161-87 and §§ 211-18. They include (1) trade or business expenses, (2) interest, (3) taxes, (4) losses, (5) bad debts, (6) depreciation, including additional first year, (7) certain amortization, (8) charitable contributions, (9) contributions to candidates for public office, (10) non-business expenses, (11) medical expenses, (12) child care, (13) alimony, and (14) moving expenses. These deductions, which are allowed under KRS § 141.010(11), are limited to those which are not deducted in arriving at adjusted gross income under KRS § 141.010(10). The amounts allowed under KRS § 141.010(11), therefore, primarily consist of personal itemized deductions because most types of business related expenditures (those deductions listed at IRC § 62) are allowed under KRS § 141.010(10). There is, then, in the Kentucky statutory pattern, the same distinction between deductions permitted in arriving at adjusted gross income and those allowable as itemized deductions as is found in the Internal Revenue Code.

<sup>141</sup> KRS § 141.010(11)(a).

early stages, it is recommended that the Kentucky General Assembly amend the taxing statute and allow the net operating loss deduction.<sup>142</sup>

The remaining deviations from the *Internal Revenue Code* do not present much difficulty. KRS § 141.010(11)(b) disallows deduction of state income taxes. This provision merely insures that individuals do not deduct *Kentucky* or *other state* income taxes in computing Kentucky net income subject to tax. It is fairly obvious that the Kentucky income tax should not be deductible in computing the base for the same tax. Denial of the deduction of sister states' income taxes can be justified by the fact that the credit device<sup>143</sup> effectively prevents double taxation and both a credit *and* a deduction should not be allowed.

KRS § 141.010(11)(c) disallows deductions allowed by the *Internal Revenue Code* which are allowed in calculating the value of the distributive shares of a decedent under KRS § 140.090(h) for Kentucky Inheritance and Estate Tax purposes. The obvious rationale for this provision is to prevent deduction of the same expenditure for both the Kentucky income and death taxes. Thus, if any deduction for costs of administration is claimed by the estate for Kentucky income tax purposes, it will not be allowed on the death tax return and a statement that it has not been so claimed must accompany the return. There is a corresponding provision in the federal income tax.<sup>144</sup>

KRS § 141.010(d) provides that there shall be no deduction for the personal exemptions allowed by IRC § 151. The reasoning

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<sup>142</sup> Cf. KRS § 141.012 and Ky. Income Tax Reg. IC-3 (1972) which allows a corporation to carry forward and deduct a net operating loss incurred during its first year of operation if certain conditions are satisfied.

Despite express disallowance of the net operating loss deduction in KRS § 141.010(11)(a), by virtue of another provision, KRS § 141.010(10), the argument can be made that there is statutory authority for the deduction when the loss is incurred in the taxpayers' "trade or business." This analysis would make the provision disallowing the net operating loss deduction applicable only to personal casualty losses and nonbusiness losses to the extent of nonbusiness income. This construction begins with KRS § 141.010(10) which incorporates by reference the deductions allowed by IRC § 62. Section 62(1) allows all deductions allowed by IRC ch. 1 (which includes § 172) that are "attributable to a trade or business carried on by the taxpayer." Thus it appears that statutory authority may exist for allowance of the net operating loss deduction, at least with respect to a loss incurred in the operation of a "trade or business." However it should be noted that, if tested, the Court of Appeals may hold that the clear expression of disallowance controls.

<sup>143</sup> See KRS § 141.070.

<sup>144</sup> IRC § 642(g) entitled "Disallowance of Double Deductions" contains similar provisions with respect to the federal income and estate taxes.

behind this provision is apparent: Kentucky allows a personal tax credit instead of a personal exemption.<sup>145</sup>

### B. *Standard Deduction*

In lieu of the itemized deductions discussed above, Kentucky allows a standard deduction of 10% of adjusted gross income up to a maximum of \$500.<sup>146</sup> Kentucky's provision was modeled upon the federal law as it existed in 1946. Both the percentage and the maximum monetary amounts have remained unchanged since first enacted by the Kentucky General Assembly.<sup>147</sup>

The federal standard deduction had been introduced in 1944 to reduce the complexities of administration and ease the burden of taxpayer compliance. In 1944 more than 82% of all taxpayers elected the simpler standard deduction to eliminate record keeping and itemizing deductions. Despite an increase in the federal maximum standard deduction to \$1000 and introduction of the minimum standard deduction, by 1965 the number of taxpayers electing the standard deduction had dropped to 58.8% of all individuals filing a federal return. This decrease was attributed to higher medical costs, interest rates, and state and local taxes, and increased home ownership, which raised the total itemized deductions of many taxpayers well above the maximum allowable standard deduction. In recognition of the desirability of simplifying the preparation and auditing of individual income tax returns, Congress responded in 1969 with a gradual increase in the standard deduction, ultimately to reach 15% with a ceiling of \$2000. The House Committee Report predicted that the change would substantially close the gap between the 58% of returns electing the standard deduction in 1969 and the 82% so electing in 1944.<sup>148</sup>

Unfortunately, Kentucky has not kept pace with the federal changes. Despite inflationary trends, its standard deduction has not been increased since its adoption in 1946. For tax year 1970, only 42% of individuals elected the standard deduction on their

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<sup>145</sup> See KRS § 141.020.

<sup>146</sup> See KRS § 141.010(11); KRS § 141.025; KRS § 141.081; KRS § 141.082 and Ky. Income Tax Reg. II-5 (1972).

<sup>147</sup> Ky. Acrs ch. 234, § 7 (1946).

<sup>148</sup> This historical discussion of the federal standard deduction is based on data obtained from H.R. REP. No. 91-413, 91st Cong., 1st Sess. 201 (1969).

Kentucky returns.<sup>149</sup> This reveals that many more individuals are resigned to the task of itemizing their deductions for Kentucky income tax purposes although they elect the standard deduction federally. Even though a taxpayer elects the standard deduction for federal purposes, he must nevertheless keep the same records and prepare the more complex return for Kentucky. A more generous standard deduction in Kentucky would remove this burden from many Kentucky taxpayers and simplify administration on the part of the Kentucky Department of Revenue.

It is possible that loss of revenue resulting from an increase in the standard deduction may be prohibitive. This is apparently the only reason why Kentucky has not yet raised the standard deduction.<sup>150</sup> However, the revenue loss may not be as substantial as it first appears. Many taxpayers have itemized deductions well in excess of the current \$500 ceiling. To illustrate the point, a taxpayer with adjusted gross income of \$9000 and itemized deductions of \$850 would itemize deductions under existing law but not if the standard deduction were raised to the 10% and \$1000 ceiling level. Thus, actual deductions would be increased only \$50 and consequent revenue loss would be much less than if figured on the basis of the \$400 difference between the standard deductions allowed. Moreover, a taxpayer with \$950 of itemized deductions may be willing to elect a \$900 standard deduction to avoid record keeping and more complex return preparation. This is especially true if the taxpayer had to pay someone to prepare his return if deductions were itemized but did not if the simpler standard deduction were elected; in this situation, he would save his tax consultant's fee. Research has uncovered no data on which to base an estimate of revenue loss if the standard deduction were increased to the current 15% level and \$2000 ceiling. However, if coupled with abolition of the federal tax deduction discussed earlier, an increase in the deduction seems especially feasible because the revenue gained thereby would more than offset revenue lost from increasing the standard deduction. In any event, as a part of the overall plan of tax revision suggested here, a study should be undertaken to

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<sup>149</sup> Computation of this percentage is based on data taken from KY. DEP'T OF REVENUE, ANNUAL REPORT 1970-1971, at A-28, A-29.

<sup>150</sup> R. Jewert, *supra* note 18, at 87, 118 and 126.

estimate revenue loss with a view toward increasing the standard deduction and thereby obtain the benefits of simplification of administration and taxpayer compliance.

#### XI. THE DOCTRINE OF UNLAWFUL DELEGATION OF LEGISLATIVE AUTHORITY AS A LIMITATION ON CONFORMITY

The doctrine of unlawful delegation of legislative authority may defeat complete federal-state income tax conformity. In essence this constitutional principle mandates that the power conferred upon the legislature to make the laws cannot be delegated by that department to any other group. This may make it impossible for the Kentucky legislature, assuming it were willing to do so, to pass a bill incorporating provisions of the *Internal Revenue Code* as they now exist and as they may be amended from time to time. Any such attempt could be held invalid as a delegation of Kentucky legislative power to Congress.<sup>151</sup> Because of this possibility, the Kentucky statute incorporates by reference only provisions of the *Internal Revenue Code* currently in effect and exclusive of any subsequent amendments.<sup>152</sup> This causes a serious problem in states like Kentucky where the legislature only meets biennially and where there is necessarily some delay in conforming Kentucky law to federal changes. It appears that absent a special legislative session this aspect of the problem cannot be avoided.

The problem of "catching-up" began in 1954 when Kentucky first substantially patterned its law after the federal. The mechanics of catching up simply require amending the definition of "*Internal Revenue Code*" to refer to the code currently in effect.<sup>153</sup> A problem in this area has been the failure of the General Assembly to amend Kentucky law to conform to the current federal code even in regular sessions. Since 1954 conforming

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<sup>151</sup> In *Santee Mills v. Query*, 115 S.E. 202 (S.C. 1922), and *Featherstone v. Norman*, 153 S.E. 58 (Ga. 1930), both courts by dicta indicated that any attempt to adopt provisions of the federal law prospectively would be unconstitutional as an unlawful delegation of legislative authority. In *Alaska S.S. Co. v. Mullaney*, 180 F.2d 805 (9th Cir. 1950), the court held an Alaska income tax law constitutional even though it was based on the *Internal Revenue Code* as amended from time to time. It should be noted that at the time of the suit no federal changes had occurred. For a collection of cases holding both ways see Annot., 166 A.L.R. 516 (1947); Annot., 147 A.L.R. 467 (1943); Annot., 133 A.L.R. 401 (1941); Annot., 79 L.Ed. 474 (1934).

<sup>152</sup> KRS § 141.010(3).

<sup>153</sup> *Id.*

legislation has been passed only four times, 1956, 1966, 1970 and 1972.<sup>154</sup> The delay in many of these interim years has created unnecessary differences between federal and state law. This legislative recalcitrance has placed a burden on the taxpayer who must be cognizant of two laws when preparing his return. It also contributes to additional confusion when the conforming amendments are finally enacted because the taxpayer would retain his knowledge of the differences he had learned from experience in previous years. It is suggested that the Kentucky General Assembly should make a conscious effort to conform to federal law at each legislative session in order to minimize differences between federal and state law.

## XII. PROCEDURAL MATTERS

### A. *Statute of Limitations and Extensions*

Under KRS § 141.210(1), the statute of limitations on assessments and refunds is set at four years from the date when the return is due or filed. However, if income is understated or omitted by 25%, the period is extended to six years. As in federal law, in cases of fraud or failure to file there is no limitation period.<sup>155</sup>

KRS § 141.210(2) provides that the statute of limitations may be extended by agreement between the department and the taxpayer. Any agreement extends the limitation period for purposes of both refund and assessment.<sup>156</sup> Whenever an extension of the statute of limitations by agreement is executed with the Internal Revenue Service under IRC § 6501(c)(4), a copy of the agreement must be submitted to the Department of Revenue within 30 days,<sup>157</sup> and under KRS § 141.210(4)(c) such agreement constitutes an extension of the statute of limitations for Kentucky tax purposes.<sup>158</sup> KRS § 141.210(3) states that the taxpayer is under a duty to notify the Department of Revenue of any federal audit within 30 days of its beginning and to submit a copy of any final determination of the audit within 30 days of its conclusion.

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<sup>154</sup> Ky. Acts ch. 4, § 1(3) (fourth special session 1956); Ky. Acrs ch. 176, § 1(3) (1966); Ky. Acrs ch. 216, § 3(3) (1970); Ky. Acrs ch. 62, § 1(3) (1972). The 1972 amendment incorporates the IRC provisions in effect on December 31, 1972.

<sup>155</sup> See also Ky. Income Tax Reg. IG-4-1 (1972).

<sup>156</sup> See also Ky. Income Tax Reg. IG-4-2 (1972).

<sup>157</sup> KRS § 141.210(4)(b).

<sup>158</sup> See also Ky. Income Tax Reg. IG-4-4 (1972).

Failure to do so suspends the statute of limitations for assessment until 90 days after notification is given.<sup>159</sup>

### B. *Department of Revenue Procedure*

Conferences with the Department of Revenue may result from an assessment of additional tax to which the taxpayer does not agree or from the denial of a refund claim filed by the taxpayer. A refund claim may be made by letter or on Revenue Form 40A713.<sup>160</sup> KRS § 141.235(3) provides that overpayments of taxes shall be refunded with interest at 6% per annum beginning 90 days after the return is due or filed. A Kentucky income tax regulation provides that interest is paid only if the refund results from clerical error by the department.<sup>161</sup> This regulation therefore seems contrary to the statutory language and may be invalid.

The Department of Revenue may require the taxpayer to keep records and furnish information necessary to correctly determine tax liability.<sup>162</sup> The department is also given subpoena power in order to ascertain the correct income of any taxpayer.<sup>163</sup> In addition, KRS § 141.160(2) provides that the department may require the taxpayer to produce a copy of his federal income tax return to aid in the auditing of his Kentucky return.<sup>164</sup>

In all proceedings before the Department of Revenue and on appeal, any applicable federal administrative and judicial interpretations serve as precedent for the resolution of Kentucky income tax questions.<sup>165</sup> Thus, when researching a Kentucky tax case, the attorney is not limited to decisions of the Kentucky Board of Tax Appeals, the Kentucky Court of Appeals or to interpretative regulations of the Kentucky Department of Revenue. Any federal rulings or decisions bearing on the matters in issue are available tools.

In the case of an assessment of additional tax or denial of a

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<sup>159</sup> See also Ky. Income Tax Reg. IG-4-4 (1972).

<sup>160</sup> Ky. Income Tax Reg. IG-4-3B (1972). A refund claim must contain the following information: (1) the taxpayer's name and address, (2) whether income is reported by calendar or fiscal year, (3) the amount previously paid, (4) the refund requested, (5) a certification that the taxpayer is not indebted to the Commonwealth for any taxes, (6) the validation number if available, and (7) the basis for the claim asserted.

<sup>161</sup> Ky. Income Tax Reg. IG-4-3a (1972).

<sup>162</sup> KRS § 141.050(2); Ky. Income Tax Reg. IG-8-1 (1972).

<sup>163</sup> KRS § 141.050(3).

<sup>164</sup> See also Ky. Income Tax Reg. IG-8-3 (1972).

<sup>165</sup> KRS § 141.050(1).

refund claim by the Department of Revenue, the taxpayer will be notified by mail.<sup>166</sup> In the absence of protest, any assessment must be paid within 30 days from the date of the Notice of Tax Due. If the taxpayer disagrees with an assessment or refund denial, a written protest may be filed with the department within 30 days and a hearing may be requested. Consideration will be given to any additional information presented in the protest and at the hearing, and the original determination by the department may be adjusted accordingly. A final appealable ruling will then be issued by the department.<sup>167</sup>

### C. Appeals

If the taxpayer is dissatisfied with any ruling, order or determination of the Department of Revenue he may, within 30 days, apply for a hearing before the Kentucky Board of Tax Appeals.<sup>168</sup> On the basis of the hearing and other documents filed, the Board will issue a written order affirming, reversing, modifying or remanding the departmental ruling. A copy of the order will be forwarded to the taxpayer and to the Department of Revenue. Assessments upheld by the Board are due and payable 30 days after the date of the order.<sup>169</sup> Any party aggrieved by a final order of the Board may file a petition of appeal on any questions of law to the Franklin Circuit Court or to the circuit court where the aggrieved party resides or does business.<sup>170</sup> Any party may appeal an adverse decision of the circuit court to the Kentucky Court of Appeals under the Kentucky Rules of Civil Procedure.<sup>171</sup> Notwithstanding the foregoing, KRS § 141.235(1) provides that no injunction shall issue restraining or delaying the collection of any tax.

## XIII. FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES

The Federal-State Tax Collection Act of 1972, enacted along with revenue sharing, authorizes the Secretary of the Treasury to

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<sup>166</sup> KRS § 141.210(1); Ky. Income Tax Reg. GA-1-1 (1972).

<sup>167</sup> Ky. Income Tax Reg. GA-1-1 (1972).

<sup>168</sup> The application for hearing must (1) be filed in duplicate, (2) contain a brief statement of the law and facts in issue, (3) contain a copy of any final action of the Department of Revenue, and (4) state the petitioner's position regarding the law or facts or both. It may contain a request for hearing. Ky. Income Tax Reg. GA-1-2 (1972).

<sup>169</sup> Ky. Income Tax Reg. GA-1-2 (1972).

<sup>170</sup> Ky. Income Tax Reg. GA-1-3 (1972).

<sup>171</sup> Ky. Income Tax Reg. GA-1-4 (1972).



enter into agreements with each state entitling the state to have its individual income tax collected and administered by the federal government. New provisions in the *Internal Revenue Code* permit each state the option to request this so-called "piggybacking" arrangement by which the state tax is collected in conjunction with the federal tax.<sup>172</sup> The purpose hoped to be achieved is more effective tax administration through the removal of duplication of state and federal collection and administrative machinery. In order to qualify, an electing state's individual income tax law must closely conform with the federal income tax. In passing the bill, Congress decided that state conformity would be feasible since many states already base their income taxes substantially upon the federal law.<sup>173</sup> However, although many states already conform their taxes to the substantive provisions of the federal code (e.g., those relating to income, deductions, etc.), the new law provides an added dimension, viz., procedural conformity through outright assumption by the Internal Revenue Service of state administrative, collection and enforcement tasks. The result will be a loss of identity of state income taxation going far beyond traditional ideas of state conformity with federal guidelines. In essence the new law establishes a national income tax, part of which is shared with the states; the states retain control over the amounts they will receive through their authority to set rates. The following discussion will first examine the variations from the federal income tax which are allowed for a state tax which qualifies under the new law. Second, some of the ramifications of the adoption of the law by Kentucky will be considered.

#### A. *General Description and Requirements*

There are two types of state individual income taxes on residents (termed "qualified resident taxes") which will be eligible for federal collection. One is based on a percentage of federal tax liability.<sup>174</sup> The other is based on federal taxable income as defined in IRC § 63.<sup>175</sup> Under this latter type the state applies its own rate structure to the federal tax base; this type is similar

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<sup>172</sup> IRC §§ 6361-65.

<sup>173</sup> SENATE COMM. ON FINANCE, S. REP. NO. 92-1050, 92d Cong., 2d Sess. 9 (1972) [hereinafter cited as SENATE COMM. ON FINANCE].

<sup>174</sup> IRC § 6362(a)(2)(B).

<sup>175</sup> IRC § 6362(a)(2)(A).

to the general scheme of the existing Kentucky income tax and will constitute the primary focus of the discussion which follows.

In enacting the new law it was recognized that the federal tax base is not an appropriate basis for state tax purposes in every respect.<sup>176</sup> Consequently, the law provides for three "mandatory" adjustments to the federal tax base as defined in IRC § 63.<sup>177</sup> The first requires subtraction of interest on United States obligations. This adjustment appears to be grounded in the doctrine of intergovernmental immunities. The second adjustment requires addition of the "net state tax deduction" to the federal tax base. "Net state tax deduction" is defined as the amount of state tax deducted under IRC § 164(a)(3) in the current year less the state tax refund included in federal gross income in the current year.<sup>178</sup> The reason for this provision is fairly obvious: the tax itself should not be deductible in computing the basis for the tax. The third "mandatory" adjustment directs that "net tax exempt income"<sup>179</sup> from obligations of a state or political subdivision which is exempt from the federal tax under IRC § 103(a)(1) is to be added to federal taxable income. The reasoning behind this adjustment is that the doctrine of intergovernmental immunities, which is the basis for the exemption of these obligations from federal tax, is not applicable in the case of a state taxing its own obligations or those of a sister state. However, recognizing the possibility that taxing a state's own obligations already exempt under a state statute may violate the contracts clause of the Federal Constitution<sup>180</sup> and thus preclude some states from entering the federal collection system, the law allows this adjustment to be made in one of three ways. Each state has the option of taxing the interest income from (1) all state and municipal obligations, (2) all state and municipal obligations except those issued prior to the date of entering the piggyback system, or (3) all state and municipal obligations except those issued by the taxing state and its political subdivisions.<sup>181</sup> If Kentucky elected to enter the federal collection system the latter alternative would have to be chosen not because the contracts clause of the Federal

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<sup>176</sup> SENATE COMM. ON FINANCE, *supra* note 173, at 48.

<sup>177</sup> IRC § 6362(b)(1)(A), (B) and (C).

<sup>178</sup> IRC § 6362(b)(3).

<sup>179</sup> IRC § 6362(b)(4).

<sup>180</sup> SENATE COMM. ON FINANCE, *supra* note 173, at 48.

<sup>181</sup> *Id.*

Constitution is violated, but because the Kentucky Constitution exempts all Kentucky state and municipal obligations from taxation.<sup>182</sup>

In addition to the "mandatory" adjustments to federal taxable income, there are two "permitted" adjustments which are optional with each state.<sup>183</sup> No otherwise "qualified resident tax" will be disqualified because it imposes a minimum tax on preferences under IRC § 56. Also, each state may allow a credit against its tax for income tax paid to another state on income which is taxed by both states. With this provision, a state may prevent its residents from being subject to double taxation.

In addition to the tax on residents, a state tax on nonresidents, a "qualified nonresident tax," may qualify for federal collection. There are four specific requirements which must be satisfied: (1) the state must also impose a "qualified resident tax," (2) the tax must be imposed by the state on all of the wage and other business income derived from sources within the state by all nonresidents, (3) the tax may only apply if 25% or more of a nonresident's wage and other business income is derived from sources within the state imposing the tax, and (4) the state must not tax the income of nonresidents more heavily than the income of residents.<sup>184</sup>

If the piggyback system should be adopted in Kentucky, employers would earmark state withholding collections and deposit them in a federal reserve bank along with federal collections. Within three business days funds so allocated would be transferred to the state. Amounts received directly by the Internal Revenue Service from declarations of estimated tax and payments with returns would be transferred to the state within 30 days.<sup>185</sup> The new system should thus reduce record keeping and reporting burdens on employers. It would also simplify tax return preparation for all Kentucky taxpayers. Taxpayers would continue to file a federal return; they would only be required to attach an additional schedule for the state computation.<sup>186</sup> In addition to collection, the new act provides for complete federal

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<sup>182</sup> See note 80 *supra*.

<sup>183</sup> IRC § 6362(b)(2)(A), (B).

<sup>184</sup> IRC § 6362(d).

<sup>185</sup> IRC § 6361(c)(1).

<sup>186</sup> SENATE COMM. ON FINANCE, *supra* note 173, at 43.

takeover of state administrative and enforcement procedures including auditing of returns by the Internal Revenue Service and litigation of Kentucky tax cases in federal courts.<sup>187</sup> The elimination of these administrative burdens would result in substantial cost savings for the Commonwealth.

### B. *Problems if Kentucky Elects Piggybacking*

Having noted some of the advantages of federal collection of state taxes, it is important to consider potential problems concerning Kentucky's entry into the system. The first hurdle is that the state law must incorporate all future amendments to the *Internal Revenue Code*.<sup>188</sup> As previously discussed, such a requirement may be an unconstitutional delegation of state legislative authority and therefore invalid.<sup>189</sup> While this appears to be the only constitutional barrier, other changes in existing Kentucky law would have to be made which would require subordination of significant existing state tax policies.<sup>190</sup>

If federal collection were elected, Kentucky's system of personal tax credits would be replaced by the federal personal exemption, the tax value of which increases as income increases, as opposed to the \$20 personal tax credit which benefits all individuals equally. Abandonment of the personal tax credit would represent a substantial departure from a firmly established state policy.<sup>191</sup>

Piggybacking would probably force adoption of income splitting in Kentucky because, under the act, individuals filing joint returns for federal tax purposes must also file jointly for state tax purposes.<sup>192</sup> Existing Kentucky law allows married individuals with separate incomes who file jointly federally to file separate Kentucky tax returns. If income splitting were not adopted as part of the new law, one of two situations would result: if taxpayers saved more Kentucky tax by filing separately than the additional federal tax paid by filing separately instead of jointly,

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<sup>187</sup> IRC § 6361(b).

<sup>188</sup> IRC § 6362(f)(2)(A). SENATE COMM. ON FINANCE, *supra* note 173, at 55.

<sup>189</sup> This possibility was also recognized by SENATE COMM. ON FINANCE, *supra* note 173, at 55. See text accompanying footnotes 151-54 *supra*.

<sup>190</sup> See Dane, *Problems Involved in Conforming a State Income Tax System with Federal Law*, 47 TAXES 94 (1969).

<sup>191</sup> Reynolds Metal Co. v. Martin, 107 S.W.2d 251, 263 (Ky. 1937).

<sup>192</sup> IRC § 6362(f)(5).

they would elect to file separately on both returns; contrariwise, if the federal tax saved by filing jointly exceeded the Kentucky tax saved by filing separately the taxpayers would elect to file jointly on both returns.

Take the case of a married couple each of whom has \$5000 of income and who file joint federal returns; the new law would require them to pay the same tax to Kentucky as a single individual with \$10,000 of income. Thus the ultimate policy judgment is whether the taxable unit should consist of the individual or the family. Should a family earning \$10,000 with one spouse employed pay more tax than the same size family with both spouses employed? Under existing law the answer is yes; however, it should be noted that revenue considerations may have dictated the result. The policy here does not appear as strong as in the case of personal tax credits and on closer examination Kentucky may resolve the question in favor of adopting income splitting.

Another federal provision whose adoption would be required is the federal standard deduction and low income allowance. This change would have the effect of exempting much larger amounts of income from taxation than the General Assembly has chosen to exempt in previous years.

As previously discussed there are several other differences between federal and Kentucky law which do not appear to the authors to represent any significant state tax policy. These are (1) the federal tax deduction, (2) disallowance of the \$100 dividend exclusion, (3) disallowance of the net operating loss deduction, and (4) nonrecognition of the Subchapter S election.

Other policies established in Kentucky tax law which would have to be dealt with in order for Kentucky to participate in piggybacking are exemption of (1) Kentucky bank stock dividends, (2) teachers' retirement income, (3) state and county employee retirement income, (4) judicial retirement income, (5) supplemental railroad retirement income and (6) in certain cases, military and civil service retirement income.

The General Assembly will have to weigh the benefits of piggybacking against the adverse effects on state tax policy to determine the desirability of adopting the measure. Some of the existing differences between federal and state law do not appear to represent any significant state policy and could be conformed

to federal law without defeating any legitimate state interest. Others would have to be more closely studied to determine whether the interest served represents a strong policy. With respect to those differences which do represent strong policies, the Committee Report suggested the possibility of implementing them in other ways, *e.g.*, providing a direct refund from the state instead of an income tax reduction under the piggyback system.<sup>193</sup> Although additional paperwork would be involved, this compromise approach may be the best alternative because significant state policies would be served without losing the benefits of federal collection and administration. However, with respect to the personal tax credit, standard deduction and nonrecognition of income splitting, the direct subsidy approach is unworkable because almost all taxpayers are affected. But where those taxpayers affected are within a limited class, as with judicial retirement, teachers' retirement and the like, the benefits of federal collection should outweigh the paperwork involved. The foregoing discussion has only hit the high points of the "piggyback" system. Because of its many potential benefits it is recommended that the General Assembly direct the Legislative Research Commission to study the system with a view toward possible adoption by Kentucky.

#### XIV. THE KENTUCKY FORM FOR INDIVIDUALS

The preparation of forms to report income for tax purposes is a necessary evil. It would not be possible to use the federal form for state income tax purposes unless the state tax were either based upon a percentage of the federal tax or the federal tax base were used as the base for computation of the state rate. In the main the Kentucky income tax forms have followed the federal where possible, differing insofar as required to give effect to differences in the tax base discussed in this article. Most of the differences between the two taxes are listed on page 10 of the Kentucky instructions.<sup>194</sup> The forms also provide space for

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<sup>193</sup> SENATE COMM. ON FINANCE, *supra* note 173, at 48.

<sup>194</sup> The items subject to the federal tax but exempted from the Kentucky tax are:

- (1) interest on United States bonds;
- (2) gain on sale of or interest from "Kentucky Turnpike Bonds;"
- (3) Dividends from Kentucky and national banks;

(Continued on next page)

the reconciliation of Kentucky income with the federal, by subtracting from Kentucky income all items which are excludable from federal gross income but not from Kentucky income (*e.g.*, the net operating loss deduction for individuals) and by adding thereto certain other items which are not includable in Kentucky income but are for federal purposes (*e.g.*, interest on U.S. bonds). The purpose of the reconciliation is to enable the Department of Revenue to readily exchange information with the Internal Revenue Service for audit compliance purposes, and of course, to allow the preparer of the return to check for accuracy.

Although Kentucky is described as a state utilizing the federal tax base, the Kentucky form now in use requires that complete independent Kentucky calculations, apart from the federal, be made. This is in contrast with the forms in some states which begin with adjusted gross income per the federal return and then provide space for adjustments—additions and subtractions reflecting the state's variations.<sup>195</sup> The latter procedure is a simpler method of calculation.

Constant revision has eliminated many minor difficulties with

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(Footnote continued from preceding page)

- (4) Kentucky teachers' retirement income;
- (5) State and county employees' retirement income;
- (6) Supplemental railroad retirement income paid by the Retirement Board;
- (7) Kentucky judicial retirement income;
- (8) Military or Federal Civil Service Retirement Income for persons 65 or older—partially exempt.

One item subject to Kentucky, though not the federal tax, is the interest on state and municipal obligations of other states.

The Kentucky form also lists, as deductible or excludible items allowed in computation of the federal tax but not the Kentucky tax, the following:

- (1) the net operating loss carry-back and carry-forward, allowed to an individual for his federal computation;
- (2) the federal dividend exclusion; and
- (3) state income taxes as an itemized deduction.

The instructions note the differences between federal law and Kentucky law in regard to recapture of section 1245 and 1250 depreciation taken, stemming from the gap in time of adoption of the federal law and the effective date in Kentucky (December 31, 1966).

In addition, as discussed heretofore in the text accompanying notes 120-23 *supra*, deduction of federal income taxes is allowed in computation of Kentucky income, though their deduction of course is not allowed on the federal return. Furthermore, Kentucky has not recognized the pass-through of income provided in the case of Subchapter S Corporations.

Another difference which is not apparent and does not appear in the tax form instructions is income splitting, which although allowed federally is not followed by Kentucky. Thus many married taxpayers with separate incomes may be lulled into thinking (and rightly since the Kentucky tax is otherwise so closely based on federal law) that because it is beneficial to file jointly federally the same is true for Kentucky.

<sup>195</sup> For example, the Illinois and Rhode Island individual income tax returns.

the Kentucky forms, but there are still a few rough spots. For example, many new residents, strangers to the Kentucky form but accustomed to the federal form and their home state's income tax form, express dismay in facing the Kentucky form. Its format differs substantially from the federal. The form is designed so that it is possible for a married couple to file jointly or separately on the same form. There are two columns designed to list the income and deductions of each spouse, on the face of the form, its reverse side, and on Schedules A, B and E. The left hand column is for the "wife" and the right hand column is for the "husband, joint or single." The first question to be answered is the meaning of the word "single," since that word has already been used in the blocks at the upper left side to indicate taxpayer's status as an unmarried person. One concludes that the word "single" following the word husband can mean either the husband when he files a *separate* return or an unmarried person filing his own return. This interpretation almost solves the dilemma of the single person who has been perusing the forms to see whether he fits the category of "husband" or "wife." The unmarried male is now at least reporting his income and deductions in the column entitled "husband, joint or single." The unmarried female, single or widowed, reports in this column, too. Actually the single person of either sex could report his income on either the wife's or the husband's side with the same effect—(if he has not already thrown up his hands and gone to the paid tax return preparer). There are also necessary computations required to apportion deductions between the husband and wife filing separately.

The Kentucky form wisely makes use of federal schedules where the Kentucky and federal definitions of income correspond. Federal schedules C (Profit or Loss from a Business or Profession), D (Capital Gains and Losses), Form 4797 (Supplemental Schedule of Gains and Losses), and F (Farm Income and Expense) are all to be attached as schedules on the state individual income tax form. Some taxpayers may momentarily be puzzled by the directions on these schedules to attach to Form 1040 (the federal return) instead of Form 740 (the Kentucky form) as well as by references in the schedules to certain sections of the *Internal Revenue Code*. However, professional tax return preparers are apt to be the persons using these schedules, and



taxpayers who prepare their own forms are likely to understand that the intention is to follow the federal provisions. Since the borrowed federal schedules do not provide separate columns for the spouses, married couples with separate transactions may need two Schedules C, D, or F to complete the Kentucky report. Kentucky Schedule E (Rents, Royalties and Other Income) is Kentucky's own form since substantive provisions (*e.g.*, the Subchapter S pass-through previously discussed) deviate from the federal sufficiently to require different calculations.

#### RECOMMENDATIONS

In making recommendations for change in the state's income tax structure, it is noted that simplification usually results from conformity of a state's income tax provisions with the federal. Simplification is often assumed to be a desirable end in itself. It not only promotes efficiency in administration and enforcement by the state revenue officials but also eases the difficulty of compliance by numerous individual taxpayers. The greatest possible degree of simplification, of course, could be accomplished by adoption of federal piggybacking. Although Kentucky may not be ready to give up the degree of control required to elect piggybacking, closer conformity with the federal law does seem desirable.

The simplification achieved through particular provisions must be weighed against other policies and objectives. Not the least of these is the state's need for revenue. If revenue is to be lost by a change in the law, does the simplification accomplished justify the loss in revenue? In this regard it is necessary to consider the connection between taxing and spending and the effect of the proposal at hand upon the predictability of revenues. When deciding whether or not to adopt a specific federal provision the state's policy-makers should balance the simplification to be accomplished against the importance of the particular state policy which may be violated. In reaching our conclusion that some of the existing Kentucky provisions should be conformed to federal law we have attempted to take account of these factors.

First and most significantly, we recommend that the federal income tax deduction be repealed for state tax purposes for the reasons urged earlier in this article. According to one estimate,

this step alone would free \$40 million in annual revenue. A small portion of this saving to the Commonwealth would be needed to offset the revenue loss from our other proposed changes. The greater portion remaining might well be used to adjust Kentucky's revenue structure in other desirable ways. Most authorities have favored abolition of the federal tax deduction as reflecting a desirable tax policy for the state.

Conformity with the federal law in regard to the dividend exclusion, Subchapter S election and the net operating loss deduction are recommended. We also favor adoption of permissible joint returns with income splitting between the spouses in the same manner as is permitted for federal income tax purposes. It is true that the desirability of each of these provisions, even as part of the federal law, is debatable as a matter of enactment in the first instance. However, with the provisions a recognized part of the federal tax system, the contrary state policies against conformity seem relatively insignificant in comparison with the desirable simplification to be accomplished. Another important change would be an increase in the Kentucky standard deduction.

As part of our proposal, the independent computations required under the existing system would be eliminated. We advocate a single Kentucky form which would pick up the adjusted gross income figure from the federal return as a starting point for the Kentucky computation. From this figure a few additions and subtractions would be made to arrive at Kentucky taxable income. We would call for elimination of all recomputations of adjusted gross income for medical expense and charitable contribution deduction purposes. Alternatively, the recomputations could be made optional with the taxpayer; in most cases they would not be elected in view of the insignificant monetary amounts involved.

The taxpayer would be required to send a copy of his federal return to the Department of Revenue along with the single page Kentucky form. On the first line of the suggested Kentucky form the taxpayer would enter adjusted gross income from his federal return. Next, one line would be provided for each of the following adjustments: (1) addition of interest on obligations of sister states, and (2) subtraction of (a) interest on United States obligations, (b) gain or interest from Kentucky Turnpike bonds,

(c) dividends from Kentucky and national banks, (d) various retirement income exempt from Kentucky taxation, and (e) state tax refunds included in federal gross income.

At this point, if income is under \$8000 and deductions are not itemized, the taxpayer would go to the tax table to figure his tax, skipping lines to be used only by those who itemized deductions or had income in excess of \$8000. For those who itemized deductions instead of using the tax table, the total of the federal itemized deductions (minus any state income tax and plus political contributions taken as a credit in lieu of a deduction on the federal return) would be subtracted. For the taxpayer who could not use the tax table because income was in excess of \$8000 and who did not itemize deductions, the standard deduction would be subtracted. The tax rates would then be applied and the credits subtracted much the same as under the existing computation.

Although the recommended changes in the form may appear difficult as described, they would greatly simplify the task of preparing the Kentucky individual income tax return. The vast majority of taxpayers would have very few, if any, of the potential adjustments. Not only would taxpayers save time and expense in preparation of returns, but the state government would also save through increased efficiency of its administrative machinery.

Very few studies have stressed the total amount of time, effort and money which the taxpaying public must expend on tax returns. Any economies achieved in this connection deserve primary emphasis.

It is hoped that the Kentucky General Assembly will give early consideration to these suggested reforms.