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Kentucky Income Tax Compared With Federal Income Tax

By CHARLES R. LOCKYER*

The federal income tax currently exercises a profound influence on the Kentucky law. This paper studies the Kentucky income tax by comparing it with the federal. The federal influence is manifested in the drafting of the state statute, in the several amendments, and through the various administrative and legal contacts with the Kentucky law. The Kentucky statute itself provides the basis for much of this close relationship. State tax administrators draw upon the federal experience in coping with the numerous intricate problems which inevitably arise.

Adoption by Kentucky of federal provisions accounts for many state income tax simplifications and illustrates the close relationship between the two laws. Simplification may result from the adoption of a feature of the federal law which reduces the complexity of certain features of compliance. For example, the use of the optional standard deduction in state returns, which was first employed in federal practice, resulted in simplification. The adoption of a federal tax feature may decrease compliance burdens even though the adopted feature is not necessarily less complex than the corresponding state feature. That is, compliance burdens diminish if both the federal and state laws employ a similar feature, such as the definition of dependents. Notwithstanding the desirability of simplification, the two governmental units are confronted with extremely different circumstances, particularly revenue requirements; it is, therefore, appropriate that differences exist.

Basic to a comprehension of the Kentucky income tax is an understanding of the federal tax. A comparison of the state tax with the federal tax will provide an insight into the nature of the state tax. Although much of the following discussion is in terms of differences, the many similarities should be borne in mind.

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The state law incorporates by statutory reference much of the federal law. Therefore, a significant portion of the comparison involves an explanation of the federal law followed by an indication as to the extent to which the state law is in agreement. The more complex federal provisions quite frequently necessitate a longer explanation than do the corresponding state provisions. Although a larger portion of this discussion may concern the federal tax, one must not lose sight of the primary purpose of the analysis, namely, an examination of the nature of the Kentucky income tax. Selected aspects of the tax laws may serve as a basis for comparison. Features designated for comparison are the scope of the taxes, returns, gross income, deductions, exemptions, allocation of income, credits for income taxes paid to other jurisdictions, rates, payments of taxes, penalties, assessment of additional taxes, and refunds. Provisions of both laws effective December, 1953 are used unless otherwise specified.

SCOPE OF THE TAXES

Much of the variation in the coverage of the two acts stems from constitutional limitations. State boundaries create problems of jurisdiction in state income taxation that are inapplicable to the federal government although the federal law is restricted along national boundaries. Both federal and state governmental units may legally apply the tax to their citizens (or residents in the case of states) regardless of the source of the income. In an attempt to avoid multiple taxation of the income that residents derive from sources within the taxing jurisdiction of other states, Kentucky provides tax credits for income taxes paid to other states.¹ Thus, the state law imposes an income tax liability upon all income regardless of the source from which derived in the case of residents, but applies only to income derived from sources within the Commonwealth for nonresident taxpayers. The federal tax is subject to no such limitation. The federal tax generally imposes a tax liability on all citizens regardless of the source of their income or their residence. Citizens that are bona fide residents of another nation during the entire taxable year may exclude income earned from sources outside the United States.² The Ken-

¹ KY. REV. STAT. 141.070 (1953).

² INTERNAL REVENUE CODE (hereinafter referred to as I.R.C.), sec. 116 (a)(1). This exception does not apply to federal employees.

tucky law regards as resident taxpayers those individuals who maintain an abode in the state even though they file federal returns as nonresident citizens.³ Nonresident aliens are liable for a federal tax on income derived from sources within the United States. Special withholding provisions are applicable to such taxpayers.⁴ Nonresidents (including nonresident aliens) are obligated to pay the state tax only on income attributable to sources within Kentucky.⁵

The application of the tax to trusts and estates varies depending upon the classification of fiduciaries as resident or nonresident. The distinction is less important to federal than to state income tax law. The residence of the fiduciary is the determinant of the obligation to file returns under the Kentucky and federal laws.⁶

The federal law requires corporations, domestic to the United States, to report their entire taxable income regardless of the sources; and corporations are taxable in the same general manner as citizens of the United States.⁷ The federal law allows domestic corporations earning income from sources outside the United States certain credits for income taxes of foreign countries attributable to such income.⁸ Under the Kentucky Act, corporations, whether foreign or domestic, are generally liable for taxes on income attributed or allocated to the state.⁹ The Kentucky law has not provided corporations domestic to Kentucky with tax treatment similar to resident taxpayers. This is so because the law imposes tax liability on only that portion of income attributable to operations in Kentucky.

Unincorporated business organizations may come within the

³ *Kentucky Income Tax Regulations*, art. 10-8.

⁴ I.R.C., Supplement H.

⁵ KY. REV. STAT. 141.010 (11) (1953) and *Kentucky Income Tax Regulations*, art. 10-8.

⁶ *Income Tax Regulations*, 111, sec. 29.161 (a) and KY. REV. STAT. 141.190 (1953).

⁷ Domestic corporations in the federal act refers to all corporations "created or organized in the United States or under any law of the United States or of any State or Territory" [I.R.C., sec. 3797 (a)(4)]. Under the Kentucky law domestic corporations are those corporations chartered by the state. The distinction between foreign and domestic corporations is important primarily in the allocation of certain types of income [KY. REV. STAT. 141.120 (1953)].

⁸ I.R.C., sec. 131 (b).

⁹ Other than the somewhat minor exception made in KY. REV. STAT. 141.120 (1953) concerning the assignment of nonbusiness income, foreign and domestic corporations are accorded the same state tax treatment (*Kentucky Income Tax Regulations*, art. 40-1).

purview of the term "corporation" for state income tax purposes under certain conditions.¹⁰ No material variation results in this respect; however variations occur from differences in types of corporations exempt in the two tax laws. The federal law exempts various specified corporations from the tax if they are nonprofit organizations.¹¹ Other corporations are partially exempt.¹² Many corporations that are exempt from the federal tax are likewise exempt from the Kentucky tax in that they qualify as "religious, educational, charitable, and other corporations not organized or conducted for pecuniary profit."¹³

In addition to the above mentioned types of corporations, state and national banks and trust companies,¹⁴ building and loan associations,¹⁵ and insurance companies¹⁶ are also exempt from the Kentucky tax. State and national banks are not exempt from the federal tax; however the federal law provides special federal income tax treatment for state and national banks.¹⁷ Building and loan associations incur federal tax liability unless they were organized before September 1, 1951, and operate "without capital stock . . . [and] for mutual purposes without profit for the purpose of providing reserve funds for and insurance of, shares or deposits."¹⁸ Insurance companies are taxable under special provision of the federal income tax law.¹⁹

RETURNS

Returns filed by the taxpayer constitute a vital relationship between the taxpayer and the tax administrator. The ensuing discussion considers important aspects such as the requirements

¹⁰ KY. REV. STAT. 141.010 (14) (1953); *Kentucky Income Tax Regulations*, arts. 10-2 and 10-3; I.R.C., sec. 3797 (a)(3); and *Income Tax Regulations*, 111, secs. 29.3797-1 and 29.3797-4.

¹¹ I.R.C., sec. 101 and *Income Tax Regulations*, 111, sec. 29.101.

¹² *Ibid.*

¹³ KY. REV. STAT. 141.040 (1953). In operation this provision results raises questions regarding the scope of the state tax. Reportedly corporations that are neither religious, educational, nor charitable claim exemption under this provision. *Kentucky Income Tax Regulations*, art. 40-1 provides for an exemption for "religious, educational, charitable, and other *like* corporations [italics supplied]."

¹⁴ Includes all state and national banks operating in Kentucky even though the exemption is allowed only if organized under the laws of Kentucky or the United States.

¹⁵ Exemption is allowed only if organized under the laws of Kentucky or the United States and if loans are made only to members.

¹⁶ KY. REV. STAT. 141.040 (1953).

¹⁷ I.R.C., secs. 23 (k), 121 and 117 (i).

¹⁸ I.R.C., sec. 101 (4).

¹⁹ I.R.C., secs. 201 (a)(1), 204, and 207.

for filing with reference to the type of return, form of the return, verification, and date of filing. Of basic importance is the requirement as to who shall file a return. Because the requirements for filing are directly related to the type of return, the comparison regarding requirements for filing necessarily involves a consideration of the type of return. This study will compare the various criteria used in imposing the general obligation to file both state and federal returns. Then, the discussion will focus on the requirements governing the use of alternative types of returns applicable to certain classes of taxpayers. The comparison pertains primarily to tax returns although the discussion is also concerned with certain information returns. It should be noted that the differences between the scopes of the two acts previously discussed may likewise result in corresponding differences in the filing requirements.

Individuals having \$600 or more of gross income must file a federal income tax return. Gross income of \$600 or more is the sole criterion in ascertaining whether there is an obligation to file. The federal law makes no reference to marital status or income of spouse if separate returns are filed. The Kentucky tax law bases the requirements to file a return on both net and gross income and the marital status of the individual.²⁰ That is, married taxpayers, living together, with either a net income of \$2,000 or more or a gross income of \$2,500 or more must file a return. Other taxpayers with either a net or a gross income of \$1,000 or \$1,500 or more respectively must file a return.

Under the federal law the age of the individual is immaterial in ascertaining whether there is an obligation to file a return. The law specifies that all income of a minor is the basis for filing a federal return and that all such income must be reported in the minor's tax return. Kentucky law regards all earned income of a minor (less than 21 years of age and unemancipated) as income of the parent or guardian.²¹ An unemancipated minor does not include earned income in his Kentucky income tax return. Other income of a minor, such as income from property or trust funds of the minor, necessitates a separate state tax return if the net or gross income from such sources is \$1,000 or \$1,500 respectively or

²⁰ KY. REV. STAT. 141.180 (1953).

²¹ *Kentucky Income Tax Regulations*, art. 180-3.

more.²² The difference in state and federal tax treatment of income earned by a minor stems from the state law regarding the ownership of such income which is not followed in the federal law.

Both the state and federal laws authorize joint returns for married taxpayers.²³ The federal law permits joint returns if the taxpayers are married at the close of the taxable year. The federal law allows married taxpayers to file joint returns even though they do not live together.²⁴ The Kentucky law permits married taxpayers to file joint returns only if living together.²⁵ Thus, the federal law authorizes joint returns by married taxpayers not living together but such returns would be unavailable for similar taxpayers complying with the state tax. Under both laws, taxpayers must be married by the close of the taxable year.

Under certain conditions, the federal law allows a joint return by the surviving spouse on behalf of a deceased spouse.²⁶ The Kentucky regulations deny the surviving spouse the right to "include the income of the deceased spouse in a joint return."²⁷ The Kentucky law prohibits a joint return by the surviving spouse.

Single returns generally facilitate administration and reduce compliance burdens. This advantage is present under both the state and federal tax laws. Under the federal law joint returns may result in lower tax liabilities as a result of the income splitting feature and aggregate exemptions allowed taxpayers filing joint tax returns.²⁸ The federal law incorporated the income splitting feature primarily to reduce inequalities between community property and common law states. This feature (income splitting) is a forceful stimulus for married taxpayers to file joint returns. The feature is not a part of the state tax law. Indeed, increased tax liabilities generally result from joint state tax returns as compared with liability under separate returns. In the absence of income splitting, higher tax rates may be applicable if the law com-

²² If the minor is married, the requirements are the same as for other married taxpayers.

²³ I.R.C., sec. 51 (b) and KY. REV. STAT. 141.180 (2) (1953).

²⁴ Individuals separated under divorce or separate maintenance decrees are not regarded as married and thereby precluded from filing joint returns.

²⁵ KY. REV. STAT. 141.180 (2) (1953) and *Kentucky Income Tax Regulations*, art. 180-1 (2).

²⁶ I.R.C., sec. 51 (b)(4).

²⁷ *Kentucky Income Tax Regulations*, art. 180-1 (2).

²⁸ Income splitting refers to the dividing of income with another person so that the taxes paid by both is less because of the graduated rates than if one had all the income.

bines the incomes of both taxpayers and taxes the aggregate as is the case of the joint state tax returns. Consequently the Kentucky law reduces the incentive to file joint state tax returns. Separate state tax returns usually provide tax savings if the combined adjusted gross income exceeds \$3,000.²⁹

In complying with the federal income tax, individuals may file a long-form return, short-form return, or a wage earner's return. Individuals who fulfill the requirements for filing the short-form return and certain additional specifications may use the wage earner's return.³⁰ Under the wage earner's form the tax administrator calculates the tax liabilities and bills the taxpayer. Individuals complying with the state tax may file either a short-form or a long-form tax return. No return comparable to the federal wage earner's return is available for state income tax purposes.

The introduction of provision for the short-form return into the federal law marked a step toward simplification. Kentucky subsequently adopted the short-form return patterned after the federal experience. Provisions applicable to the use of short-form returns are therefore similar in many respects. Differences do exist between the two laws pertaining to the requirements governing the use of the short-form return. The federal law specifies that the short-form return is available to individuals having adjusted gross income of less than \$5,000.³¹ The source and nature of the income is immaterial. The Kentucky law provides that individuals with an adjusted gross income of \$5,000 or less may file the short-form return,³² but for state purposes the taxpayer must derive income entirely from personal services, except that he may include income from interest, dividends, and annuities not in excess of \$100 in the short-form return.³³ Perhaps the most significant difference in the requirements governing the use of the short-form returns under both laws results from this restriction. In this respect, the requirements found in the Kentucky law for the use of the short-form return are quite similar to those of the federal law and the use of the wage earner's form.³⁴

²⁹ Kentucky Department of Revenue, "Kentucky Individual Income Tax Return," form 740, p. 4 (1953).

³⁰ I.R.C., sec. 51 (g).

³¹ I.R.C., sec. 400.

³² Ky. REV. STAT. 141.055 (1953).

³³ *Ibid.*

³⁴ I.R.C., sec. 51 (f).

In addition to the above variations in the requirements for the use of the short-form return, differences exist as a result of diversities in the concept of adjusted gross income. For example, adjusted gross income under the federal income tax law, unlike state practice, makes no allowances for federal or state income taxes. That is, the federal law allows no deduction for federal income taxes. Although state income taxes are ultimately deductible they are not deductible for the purpose of computing adjusted gross income. In calculating adjusted gross income for state income tax purposes, the taxpayer adds federal income tax refunds as taxable income. Kentucky income taxpayers subtract federal income tax withheld during the year, additional federal tax assessments, and payments by declaration in computing adjusted gross income. It is apparent that the Kentucky law restricts the use of the short-form return in referring to the sources of income; differences in adjusted gross income concepts with specific reference to the deduction of federal income taxes operate in the reverse.

For effective administration of income taxes both tax laws require numerous other reports in addition to tax returns. One of the significant differences between the federal and Kentucky income taxes resulting in radically different administrative procedure is that the federal law provides for a current collection program. The state generally collects the tax during the course of the following tax year. Federal current collections utilize numerous returns and reports that the Kentucky income tax law does not require. There is a partial exception in the withholding of income of certain nonresident taxpayers.

Fiduciaries for individuals and estates must file a federal income tax return if the gross income is \$600 or more.³⁵ Fiduciaries for trusts having a net or gross income of \$100 or \$600 or more respectively must file a return. The federal law requires a return from all estates or trusts of which any beneficiary is a nonresident alien. The state law bases filing requirements applicable to fiduciaries for living individuals upon the net and gross incomes in accordance with the marital status of individuals for whom the fiduciary acts.³⁶ Other fiduciaries must file a state return if any

³⁵ I.R.C., sec. 142.

³⁶ KY. REV. STAT. 141.190 (1953) and *Kentucky Income Tax Regulations*, art. 190-1.

taxable income is earned.³⁷ Thus, the federal law bases requirement for filing fiduciary returns on net or gross income corresponding to the exemption or deduction allowed. The state is substantially similar to the federal except that the Kentucky law requires a return if any taxable income is received.

Neither the state nor the federal tax laws impose tax liability on partnerships as such; however both laws require information returns.³⁸

The federal law requires all corporations to file a tax return even though they currently earn no income. The federal law relieves from the requirement of filing tax returns corporations expressly exempt from the tax and those which have been chartered but have never perfected their organization, transacted any business, or received income from any source.³⁹ The Kentucky provisions pertaining to the general filing requirements for corporations are practically identical with the federal law.⁴⁰ The federal law authorizes certain affiliated groups of corporations to file consolidated returns.⁴¹ The Kentucky statute prescribes separate returns for affiliated taxpayers.⁴²

Form of the tax returns necessitates but brief mention. The Kentucky statute specifies that the department "prescribe forms identical with those utilized by the Federal Government."⁴³ Variations in the several forms stem from differences in the tax law and its application. In view of the fact that the discussion makes a comparison of the salient features of two tax laws and indicates variations between the two tax laws, the discussion makes no itemization of variations that result in modifications in the form of the state return.

As authorized by federal statute, the Treasury Department by regulation permits taxpayers to verify returns by written declara-

³⁷ *Kentucky Income Tax Regulations*, arts. 190-2 to 190-5. The law requires a return if such income is distributed or distributable. Certain fiduciaries may deduct distributed income.

³⁸ KY. REV. STAT. 141.110 (1953) and *Income Tax Regulations*, 111, sec. 29.187-1.

³⁹ *Income Tax Regulations*, 111, sec. 29.52-1.

⁴⁰ *Kentucky Income Tax Regulations*, art. 200-1.

⁴¹ I.R.C., sec. 141-1. The surtax rate is increased by 2 percentage points for corporate taxpayers filing consolidated returns.

⁴² KY. REV. STAT. 141.200 (1) (1953).

⁴³ KY. REV. STAT. 141.050 (1) (1953). In order that the state statute not constitute an unconstitutional delegation of legislative authority, the provision must be construed to have reference to federal practices effective at the time the General Assembly enacted the provision.

tion made under the penalties of perjury in lieu of the oath otherwise prescribed.⁴⁴ Penalties for perjury apply to individuals who wilfully make and subscribe to returns known to be false. The federal law requires verification by oath or affirmation for all other federal income tax returns. Like the federal law, the state law specifies that individual taxpayers verify state income tax returns by a written declaration under the penalties of perjury and the law requires no oath.⁴⁵ State law requires an oath on all state returns other than individual returns.⁴⁶ Oaths made by fiduciaries under both the federal and state laws must declare that the fiduciary has sufficient knowledge of the affairs in addition to a statement affirming the accuracy of the data.⁴⁷ The federal and state laws require that a copy of the will or other trust instrument must be on file or accompany the tax return of the fiduciary. Under both laws, information returns of partnerships must be sworn to by a member of the partnership.⁴⁸ Corporation returns must be sworn to by the president, vice-president, or other principal officer and by the treasurer, assistant treasurer, or chief accounting officer under both laws.⁴⁹ Both the state and federal laws require oaths for all returns, if someone other than the taxpayer files the return.

Most federal income tax returns must be filed on or before the fifteenth day of the third month following the close of the taxable year. Fiduciary returns are due on or before the fifteenth day of the fourth month. Kentucky income tax returns are, in general, due one month after the federal due date. Thus, all Kentucky income taxpayers, except fiduciaries, may file their state returns within one month after the federal due date without incurring penalties for late returns.

GROSS INCOME

Gross income refers to the aggregate taxable income included in the tax base before subtracting certain amounts such as deductions and allowances. Gross income is based upon a concept of

⁴⁴ I.R.C., sec. 3809 (c) and *Income Tax Regulations*, 111, sec. 29.51-4.

⁴⁵ KY. REV. STAT. 141.180 (4) (1953).

⁴⁶ KY. REV. STAT. 141.200 (2) and 141.190 (2) (1953).

⁴⁷ I.R.C., sec. 142 (b) and KY. REV. STAT. 141.190 (2) (1953).

⁴⁸ I.R.C., sec. 137 and KY. REV. STAT. 141.200 (2) (1953).

⁴⁹ I.R.C., sec. 52 and KY. REV. STAT. 141.200 (2) (1953).

income with certain modifications. A consideration of the concept is of paramount importance inasmuch as gross income is so directly related to the tax base itself. With important exceptions, there is a strong similarity between the concept used in the federal and Kentucky income tax laws. Important aspects, in which differences exist, relate to gains or losses on sale or exchange of capital assets, interest on government bonds, liquidating dividends, dividends of state and national banks and trust companies situated in Kentucky, distributions by certain affiliated corporations, and returns of amounts previously deducted such as federal income tax refunds.

One of the most significant differences in the concept of gross income in the federal and state income taxes is the tax treatment of gains or losses from the sale or exchange of capital assets.⁵⁰ The federal method of taxing such income has varied considerably over a period of years. Notwithstanding numerous modifications in the law, the federal law has traditionally asserted a tax liability to such income. Special provisions apply to income realized from the sale or exchange of capital assets. The Kentucky law ignores, for tax purposes, gains and losses from assets held more than two years. The Kentucky law taxes income from the sale or exchange of capital assets held less than two years as ordinary income. The Kentucky law also permits a deduction for losses from such transactions. Thus, a basic difference results. The federal tax liability clearly extends to capital gains and losses whereas the state law restricts the liability to recurrent receipts resulting from or closely approximating inventory transactions. One might properly regard the two year period as an arbitrary time period to segregate inventory and capital transactions in the Kentucky law.⁵¹

Significant differences in the definitions of gross income are at least partially attributable to constitutional considerations.⁵² The Kentucky and federal income tax laws variously treat interest from governmental securities or the securities of governmental instru-

⁵⁰ It should be noted that the immediate discussion is concerned with inclusions in gross income, therefore, it is capital gains which are included. Capital losses which may offset capital gains or be deducted from other income are discussed with other deductions.

⁵¹ The fact that the federal income tax law for taxable years, 1922 to 1933, contained a two-year period, probably accounted for the adoption by Kentucky.

⁵² See B. U. RATCHFORD, *Intergovernmental Tax Immunities in the United States*, VI NATIONAL TAX JOUR., 305-332 (December, 1953) for an analysis of constitutional immunity.

mentalities. The federal law groups interest from such instruments as wholly exempt, partially exempt, or entirely taxable. Wholly exempt instrumentalities include all obligations of states, territories, and political subdivisions thereof,⁵³ including counties, cities, towns, townships, and school districts. That is, any division of the state invested with the authority to exercise part of the sovereign power of the state is within the definition of political subdivisions. One might attribute the federal exemption to the widely held belief that such income is constitutionally exempt under the doctrine of implied immunity. Courts have broadly construed the federal statute with respect to this exemption, to include all interest from many types of governmental agencies. Interest from securities of political subdivisions is exempt even though arising from the more recent types of governmental instrumentalities such as the Port of New York Authority.⁵⁴ A federal Circuit Court of Appeals held the Port of New York Authority to be a state instrumentality and income from securities of such governmental unit exempt from the federal income tax. The Commissioner contended that the exemption antedated the type instrumentality and was not a part of the constitutional doctrines of 1913. The court denied that the Supreme Court in *Helvering v. Gerhardt* cleared the way for extending the federal income tax to such interest income.⁵⁵ The *Shamberg's Estate* case was concerned with the statutory construction of the exemption; the Supreme Court has not passed on the constitutional question of applying an income tax to such income. Although the Treasury Department has urged repeal of this exemption it remains intact. Interest on certain federal obligations may also be wholly exempt from federal tax; taxpayers need not include such interest in gross income.⁵⁶ Interest on other federal obligations may be subject to

⁵³ I.R.C., sec. 22 (b)(4) and *Income Tax Regulations*, 111, sec. 29.22 (b) (4)-1.

⁵⁴ *Commissioner of Internal Revenue v. Shamberg's Estate*, 144 F. 2d 998, certiorari denied, 323 U.S. 792 (1944).

⁵⁵ 304 U.S. 405 (1938).

⁵⁶ I.R.C., sec. 22 (b) and *Income Tax Regulations*, 111, sec. 29.22 (b)(4). Included in this category are federal obligations issued before September 1, 1917; United States Treasury certificates of indebtedness, notes, and bills issued prior to March 1, 1941; Postal Savings Bonds and deposits issued or made before March 1, 1941; Panama Canal Zone 3 per cent bonds due in 1961; Puerto Rico bonds; Philippine bonds issued before March 24, 1934; United States Treasury and United States Savings bonds issued before March 1, 1941 in principal amounts of \$5,000 or less; and obligations of corporations organized by acts of Congress prior to March 1, 1941 if so provided in the acts.

the federal surtax but exempt from the normal tax and is therefore partially exempt.⁵⁷ Interest on obligations of the United States issued on or after March 1, 1941 is subject in entirety to the federal income tax. The Public Debt Act of 1941 specified that "Interest upon . . . obligations issued on or after the effective date of this Act [March 1, 1941] by the United States or any agency or instrumentality thereof shall not have any special treatment, as such, under Federal Tax Acts now or hereafter enacted. . . ."⁵⁸

The Kentucky income tax provides for the exemption from gross income of interest on obligations and instrumentalities of the United States.⁵⁹ The exemption doubtless reflects the constitutional doctrines prevailing in 1936. The Supreme Court in *Graves et al., Commissioners Constituting the State Tax Commission of New York v. New York ex rel. O'Keefe* may have cleared the way for states to impose nondiscriminatory income taxes on interest on federal instrumentalities.⁶⁰ The Supreme Court of Pennsylvania recently held invalid provisions of the Pennsylvania corporation income tax imposing a tax on federal securities on the ground of discrimination rather than implied immunity *per se*.⁶¹ The Kentucky law exempts interest on obligations of Kentucky or of its political subdivisions and municipalities and instrumentalities.⁶² Interest from obligations of states or political subdivisions other than Kentucky incurs a tax liability under the Kentucky income tax law. Significant differences between the federal and state income tax laws with respect to the taxation of interest from governmental securities are apparent.

There are several differences between the provisions of the federal and Kentucky income tax laws regarding the tax treatment of various types of dividends. The tax treatments applicable to liquidating dividends vary. The federal law regards such dividends as a sale of stock and the income constitutes a capital gain or loss to the stockholder.⁶³ The law classifies the gain or loss as

⁵⁷ I.R.C., sec. 22 (b). See Commerce Clearing House, *Standard Federal Tax Reporter*, (1953) Vol. 1, sec. 107.015 pp. 2133 ff., for tables indicating the tax status of interest on obligations of the United States and possessions.

⁵⁸ 55 STAT. 9 (1941).

⁵⁹ KY. REV. STAT. 141.010 (6)(e) (1953).

⁶⁰ 306 U.S. 466 (1939).

⁶¹ *Commonwealth v. Curtis Publishing Co.*, 363 Pa. 299, 69 A. 2d 410 (1949).

⁶² KY. REV. STAT. 141.010 (6)(e) (1953).

⁶³ I.R.C., sec. 115 (c).

either short or long-term depending upon the period the asset was held and imposes a tax accordingly.

The Kentucky tax law may impose a tax liability upon the recipient of liquidating dividends. The Kentucky liability attaches if the dividend does not represent a return of the corporation's capital and represents income to the shareholder.⁶⁴ This portion is gross income and fully taxable to the recipient. The purpose of the Kentucky provision is to avoid situations in which "all dividends received by stockholders could be made to escape taxation by the process of having the corporation postpone a declaration of dividends over a period of years and then make distribution by the process of liquidation."⁶⁵ The Kentucky law imposes a tax on liquidating dividends to the extent the dividend represents earned surplus of the corporation and income to the recipient. One might regard such tax treatment as a manifestation of the legislature's intent to tax recurrent receipts and largely exclude capital gains from taxation.⁶⁶

Dividends paid by state and national banks and trust companies incur a federal income tax liability to the recipient, and taxpayers must include such income in gross income.⁶⁷ The Kentucky income tax law allows a deduction for dividends received from "stock of national banks and of banks and trust companies organized under the laws of this state."⁶⁸ Although such dividends are technically a deduction, the regulations exclude such income by prescribing that taxpayers need not report such dividends as gross income.⁶⁹ These differences are traceable in part to provisions regarding state taxation of banks under the famous Section 5219 of the *United States Revised Statutes*.⁷⁰ In general, states may select any one of four alternative methods of taxing

⁶⁴ KY. REV. STAT. 141.010 (3) (1953).

⁶⁵ *Reeves, Commissioner of Revenue v. Turner et ux.*, 289 Ky. 426, 158 S. W. 2d 978 (1942).

⁶⁶ Accordingly, the two year period applicable to capital gains and losses is inapplicable to liquidating dividends. See *Reeves v. Turner* for further consideration of the distinction between the federal and Kentucky income tax treatment of liquidating dividends.

⁶⁷ Dividends on obligations of federal land banks, federal reserve, and national farm loan associations issued prior to March 28, 1942 are exempt. The exemption extended to federal reserve banks does not apply to member banks (*Income Tax Regulations*, 111, sec. 29.22 (b)(4)-2).

⁶⁸ KY. REV. STAT. 141.080 (9) (1953).

⁶⁹ *Kentucky Income Tax Regulations*, art. 10-19.

⁷⁰ U.S.C.A., Title 12, sec. 548.

national banks. Inasmuch as Kentucky imposes a capital stock tax on national banks, an income tax applicable to national banks is beyond the prerogative of the Commonwealth. Like most of the other states, Kentucky also exempts state banks from the income tax. Apparently the legislature regarded an income tax exemption granted to state banks as being less objectionable than resulting adverse competitive effects to state banks if the tax applied only to state banks.

Another difference in the gross income concepts concerns the inclusion of distributions of stock of subsidiary corporations. This difference stems from recent state income tax legislation excluding dividends in voting stock of an 80 per cent owned subsidiary received by the parent corporation's shareholders.⁷¹ The federal law regards such distributions as dividends in property and therefore taxable.⁷² The federal law taxes dividends in stock to the recipient even though the distribution makes no change in the proportionate interests in either the corporation distributing the dividends or corporations whose stock is distributed.⁷³ The Revenue Acts of 1932, 1928, 1926, and 1924 all contained similar provisions whereby the law recognized no gain to the distributee of similar dividends in stock if the distribution results from a reorganization plan.⁷⁴ Since 1934, the revenue laws include no similar provisions, and currently the federal law imposes a federal tax liability on such distributions.

Another less basic difference in the gross income concepts results from the inclusion in gross income of federal income tax refunds for Kentucky tax purposes. The federal income tax law regards such refunds as excess payments and excludes them from gross income.⁷⁵ Tax refunds represent taxable income for state purposes only if they were previously deducted. Under the state law such refunds are excessive deductions already taken and taxpayers are required to offset the excess by including them in gross income. In addition to federal income tax refunds, refunds of

⁷¹ Ky. Acts 1952, c. 226.

⁷² *Income Tax Regulations*, 111, sec. 29.115-10. Other dividends in property are taxable under the Kentucky tax (*Kentucky Income Tax Regulations*, art. 10-20).

⁷³ *Cheley v. Commissioner of Internal Revenue*, 131 F. 2d 1018 (1942).

⁷⁴ Revenue Acts of 1932 and 1928, sec. 112 (g) and Revenue Acts of 1926 and 1924, sec. 203 (c).

⁷⁵ I.R.C., sec. 22 (b)(12) and *Income Tax Regulations*, 111, sec. 29.22 (b)(12)-1.

other previously deducted items may create similar differences as a result of variations in the deductions previously allowed for purposes of each tax.

The federal individual income tax law permits taxpayers who receive lump sum compensation for services performed over a period of 36 months or more to prorate their income over a period more closely correlated to the services.⁷⁶ Although the statute makes no provision for prorating income, the department has allowed taxpayers to prorate such income in the same manner as the federal law provides.

Another important aspect resulting in different tax treatment concerns the taxation of income of military personnel. Members of the armed forces generally incur a federal income tax liability on their income. Service connected compensation of enlisted personnel for services in combat zones after June 24, 1950, as well as compensation for hospitalization at any place as a result of wounds, diseases or injury sustained in a combat zone is specifically exempt from taxation.⁷⁷ The federal law extends the exemption to commissioned officers but limits the amount to the first \$200 of monthly compensation. The federal law requires members of the armed forces and not the dependents to include allowances paid to families of servicemen as taxable income. The federal tax law treats the portion of the allowance that the federal government contributes as a gift and therefore tax exempt. Pensions or annuities are exempt only if paid by reason of service connected disability.⁷⁸ The state tax law excludes from gross income all income received from the federal government by members of the armed forces or dependents during the national emergency.⁷⁹ There are also certain federal laws pertaining to the taxation of income of members of the armed forces directly affecting the application of state income taxes to such income. According to the Soldiers' and Sailors' Civil Relief Act of 1940, as amended, individuals inducted into the armed forces retain the same domiciles as they had at the time of induction.⁸⁰ It also specifies that "compensation for

⁷⁶ I.R.C., sec. 107 (a)(b) and *Income Tax Regulations*, 111, sec. 29.107.

⁷⁷ I.R.C., sec. 22 (b)(13) and *Income Tax Regulations*, 111, sec. 29.22 (b)(13)-2.

⁷⁸ I.R.C., sec. 22 (b)(5).

⁷⁹ KY. REV. STAT. 141.010 (6)(f) (1953).

⁸⁰ 54 STAT. 1178 (1939-1941) as amended by 56 STAT. 777 (1942) and 58 STAT. 722 (1944).

military or naval service [received by members of the armed forces not resident of or domiciled in a given state] shall not be deemed income for services performed within, or from sources within, such state. . . ." and thereby removed such income from the tax base which might otherwise possibly incur a tax liability as a non-resident taxpayer.⁸¹

DEDUCTIONS

Closely related to the analysis of the comparison of gross income concepts are the various deductions allowed in calculating net income. As in the case of gross income, deductions from gross income are quite similar in both acts. Both federal and state tax laws allow taxpayers deductions only if specifically authorized.⁸² Both laws place considerable emphasis upon adequate verification, particularly on adequate accounting records of income taxpayers. Under both acts, deductions for business connected expenses are deductible on either a disbursement or accrual basis. The Kentucky law allows deductions on a cash or accrual basis.⁸³ The state statutory provision for deduction of taxes and repairs does not specifically provide for accrual accounting. The Department has construed the legislative intent to allow deductions on either a cash or accrual basis, depending upon other accounting records of the taxpayer.⁸⁴ Important to individual taxpayers is the distinction between "deductions for adjusted gross income" and "other deductions" or "deductions for net income."⁸⁵ The "deductions for adjusted gross income" are important to those taxpayers contemplating the use of the short-form return or the standard optional deduction in lieu of itemizing the "other deductions." The Kentucky General Assembly patterned the state concept of adjusted gross income after the federal law. As a result, no important difference between the two laws with respect to "deduc-

⁸¹ U.S.C.A., Title 50, sec. 574.

⁸² *Deputy et al. v. du Pont*, 308 U.S. 488, 60 Sup. Ct. 363 (1940); *New Colonial Ice Co., Inc. v. Helvering*, Commissioner of Internal Revenue, 292 U.S. 435 (1934); and *Bigelow v. Reeves*, Commissioner of Revenue, et al., 285 Ky. 831, 149 S.W. 2d 499 (1941).

⁸³ KY. REV. STAT. 141.080 (1953).

⁸⁴ James W. Martin, "Kentucky Income Tax Compared with Federal Income Tax," *TAXES—THE TAX MAGAZINE*, XV (January, 1937), p. 27.

⁸⁵ "Deductions for adjusted gross income" are those deductions which taxpayers may subtract from gross income to calculate adjusted gross income.

"Deductions for net income" are those items which taxpayers may subtract from adjusted gross income for purposes of computing net income. The term "deductions for net income" is synonymous with "other deductions."

tions for adjusted gross income" and "other deductions" exists. For purposes of comparison, one might group deductions as expenses, including depreciation and depletion, losses, interest, taxes, rent, contributions, medical expenses, and allowances for intercorporate dividends.

The corresponding sections of the federal and Kentucky statutes authorizing a deduction for ordinary and necessary business expenses including those non-trade or non-business expenses of an individual are almost identical.⁸⁶ The federal law authorizes a deduction for "compensation for personal services actually rendered"⁸⁷ whereas the Kentucky statute authorizes the corresponding deduction for "compensation paid for personal services actually rendered."⁸⁸ State regulations and recent legislation have avoided a possible difference between the two laws by regarding the deductions as authorized if "paid or incurred."⁸⁹ In general, the deductions allowed for expenses of a business and a non-business character are the same in both laws.⁹⁰ Both laws permit allowances for depreciation, obsolescence, and depletion. The Kentucky statute adopts by reference federal provisions regarding such allowances and to some extent the two are in agreement.⁹¹ The General Assembly adopted federal provisions effective August 7, 1936 for timber and specified natural resources. In the light of subsequent federal legislation substantial differences exist between federal and state allowances.

Losses may result from various causes. Income tax treatment of losses is generally related to the cause of the loss. For example, losses from operations, from involuntary conversion, and from the sale or exchange of capital assets are usually subject to special tax provisions. The federal law authorizes deductions for net

⁸⁶ Compare I.R.C., secs. 23 (a)(1) (A) and 23 (a)(2) with KY. REV. STAT. 141.080 (1) (1953).

⁸⁷ I.R.C., sec. 22 (a)(1) (A).

⁸⁸ KY. REV. STAT. 141.080 (1) (1953).

⁸⁹ *Kentucky Income Tax Regulations*, arts. 80-5 and 140-8 (a). The creation in 1952 (Ky. Acts 1952, c. 194 sec. 4) of section 141.079 numbered KY. REV. STAT. 141.075 (1953) is additional evidence of the legislature's intention that such deductions also be taken on an accrual basis.

⁹⁰ As used in both laws, the term "nonbusiness" deduction refers to those items of expense incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. They differ from those items of expense connected with a trade, business, or profession.

⁹¹ KY. REV. STAT. 141.080 (8) (1953).

operating losses.⁹² The federal law allows taxpayers to carry back and forward net operating losses as subtractions against other income. The Kentucky law provides for no such device. States have generally avoided this deduction in view of the jurisdictional limitations of states, the much lower state rate levels and the state's balanced budget objectives.

Losses realized from the sale or exchange of capital assets receive different tax treatment in the federal and state tax laws. The federal law allows individuals a deduction for net losses up to a maximum of \$1,000.⁹³ In addition, the federal law specifies that taxpayers may carry forward in the next five years any disallowed portion of the net loss as a short-term capital loss. The federal law denies corporations sustaining a net capital loss a deduction in the year realized and specifies that corporations may use such loss as an offset against any capital gain of the next year.⁹⁴ The Kentucky income tax law allows a deduction for losses realized from the sale or exchange of capital assets held two years or less.⁹⁵ The Kentucky law places no maximum upon such deductible losses nor does it provide for the carrying forward of any capital loss in excess of other income.

In addition to the above difference related to capital losses the Revenue Act of 1951 created another significant difference in this area. The federal law now allows a deduction from gross income for 50 per cent of the excess of the net long-term capital gain over the net short-term capital loss, if any.⁹⁶ The Kentucky law makes no corresponding allowance.

Both laws contain specific authorization for a deduction for all interest of a business or non-business nature.⁹⁷ In both laws, the deduction does not apply to interest paid or accrued to purchase or carry property that produces tax exempt income.

In the area of deductions from gross income, the deduction for taxes results in important differences in the federal and state income tax laws. All taxes paid or incurred by individuals and

⁹² I.R.C., sec. 122. Provisions for individual and corporate taxpayers are similar except that carry-over provisions differ with respect to new corporations with 1947 losses.

⁹³ I.R.C., secs. 117 (a)(10) (B); 117 (e)(1); and *Income Tax Regulations*, 111, sec. 29.117-2 (c).

⁹⁴ I.R.C., sec. 117 (d)(1) and *Income Tax Regulations*, 111, sec. 29.117-2.

⁹⁵ KY. REV. STAT. 141.100 (1953).

⁹⁶ I.R.C., secs. 23 (ee) and 117 (b).

⁹⁷ I.R.C., sec. 23 (b) and KY. REV. STAT. 141.080 (2) (1953).

corporations and incurred in a trade or business are deductible under both laws as expenses.⁹⁸ In the case of corporations, most taxes are generally expenses. Corporations may therefore deduct taxes insofar as the corporation paid or incurred such taxes as business expenses. Both the state and federal income tax laws allow in substantially the same manner deductions for taxes that are business expenses of corporations. In addition to the allowance for taxes that are business expenses, both laws permit deductions for other specified taxes. The federal law allows a deduction for all state and local taxes with the exception of death taxes, gift taxes, and special assessments (unless for maintenance or repair). The federal law also treats taxes imposed by foreign countries as deductible items. Under the Kentucky law, "Property taxes, poll taxes, and franchise or license taxes paid to this state or its taxing subdivisions, and income taxes paid to the United States" are deductible from gross income.⁹⁹ The Kentucky law specifically denies a deduction for state income taxes.¹⁰⁰ Thus, deductions allowed for taxes that are not business expenses vary widely in the federal and Kentucky tax laws. State and local taxes are generally deductible under the federal law, but Kentucky restricts such deductions to taxes imposed by Kentucky or its taxing subdivisions. The state tax allows a deduction for federal income taxes which the federal law denies. This deduction for federal income taxes is an allowance of far reaching significance.¹⁰¹

Within limits, both state and federal income tax laws allow individuals a deduction for contributions to certain types of recipients. The maximum amount of such deductions varies between the two tax laws. In the federal law such contributions may not exceed 20 per cent of adjusted gross income.¹⁰² The state statute provides for a deduction limited to 15 per cent of net income.¹⁰³ The significance of this distinction between the two laws depends upon the differences in percentage allowances and upon the amount of deductions from adjusted gross income that

⁹⁸ I.R.C., sec. 23 (a) and KY. REV. STAT. 141.080 (1) (1953).

⁹⁹ KY. REV. STAT. 141.080 (3) (1953).

¹⁰⁰ KY. REV. STAT. 141.090 (7) (1953).

¹⁰¹ See Charles R. Lockyer and James W. Martin, *Some Kentucky Income Tax Discriminations*, 39 Ky. L. J., 377-391 (1951) for an analysis of the effects of this deduction.

¹⁰² I.R.C., secs. 22 (n) and 23 (o).

¹⁰³ KY. REV. STAT. 141.080 (10) (1953). "Net income" refers to net income calculated without consideration of this deduction.

the state law authorizes. Although differences exist between the two income concepts in the respective laws, the Kentucky maximum is less than the federal. The maximum contribution allowed corporations under both laws is 5 per cent of net income computed without benefit of this deduction.¹⁰⁴

In addition to differences as to the maximum amount deductible, there are differences regarding the geographical location of certain recipients of such contributions. The Kentucky statute authorizes a deduction for contributions to Kentucky or its political subdivisions.¹⁰⁵ The statute also allows a deduction for contributions to veterans organizations if nonprofit and organized in Kentucky. In addition the state income tax law grants a deduction for contributions made to fraternal societies, orders, or associations if such contributions are to be used for religious, charitable, scientific, literary, or educational purposes in Kentucky. The federal law makes no such limitation but grants the deduction only if the organization is chartered under the laws of the United States, states, territories, or possessions, and thereby excludes foreign organizations.

The state and federal income tax laws authorize a deduction for extraordinary medical expenses.¹⁰⁶ To be deductible, the taxpayer must make such payments for the medical care of the taxpayer, spouse, or dependent.¹⁰⁷ No differences in the two statutes exist regarding the nature or type of medical expenses deductible. There are differences regarding the size of such deductions. Both laws allow a deduction for medical payments in excess of 5 per cent of adjusted gross income. The federal law limits the maximum deductions on a joint federal tax return to \$1,250 for each exemption but not in excess of \$5,000. The Kentucky maximum

¹⁰⁴ I.R.C., sec. 23 (q) and KY. REV. STAT. 141.080 (10) (1953).

¹⁰⁵ I.R.C., sec. 23 (x) and KY. REV. STAT. 141.080 (13) (1953).

¹⁰⁶ Inasmuch as there are variations between the two laws regarding the definition of "dependents" and "marital status," corresponding differences may result in the determination of whether a given payment is made for the medical care of "the taxpayers, spouse or dependent." In the federal law the definition of "dependent" is broader for purposes of the medical expense deduction than for the exemption: Only the support and relationship conditions must be met for the medical expense allowance. That is, if otherwise qualified the medical deduction is allowable even though the dependent's gross income is \$600 or more and/or the dependent filed a joint return with his or her spouse [I.R.C., secs. 23 (x) and 25 (b) (3)]. The Kentucky law makes no such differentiation. By reference, the terms are identically defined [KY. REV. STAT. 141.080 (13) (1953)].

¹⁰⁷ It should be indicated that adjusted gross income as used in the two tax laws differs.

for such a return is \$2,500. The \$2,500 maximum applies "in the case of a head of a family, or husband and wife filing a joint return, or husband and wife filing separate returns each claiming one or more dependents."¹⁰⁸ As a result of the Revenue Act of 1951 the federal law accords more liberal treatment to federal taxpayers with respect to medical expenses if the taxpayer or spouse attained age 65 before the end of the taxable year.¹⁰⁹ This act removed the limitation of 5 per cent of adjusted gross income applicable to the deduction for medical expenses paid for the medical care of a taxpayer or spouse if 65 years of age or more. The state legislature patterned the medical expense deduction after the federal law in effect prior to the Revenue Act of 1951. The General Assembly has not amended the state law in such a manner as to allow Kentucky income taxpayers more liberal medical expense deductions comparable with those under the federal law.

An important feature of the federal corporation income tax is the tax credit allowed for 85 per cent of the dividends received from domestic corporations.¹¹⁰ For technical reasons, Congress changed this allowance in 1936 to a credit against income rather than an exclusion from gross income.¹¹¹ The use of this allowance in the federal law constitutes an attempt to avoid, to a certain extent, multiple taxation of corporate income. Having made the allowance, various precautions in the form of numerous additional and modifying rules were necessary to avoid possible tax avoidance through various corporate devices. The Kentucky income tax contains no similar provisions granting an allowance for inter-corporate dividends.

EXEMPTIONS

Firmly entrenched in the theory of individual income taxation is the personal allowance granted taxpayers for themselves and their dependents. This is so even though there is a marked divergence in the theoretical justification for such allowances. The

¹⁰⁸ *Kentucky Income Tax Regulations*, art. 80-46.

¹⁰⁹ I.R.C., sec. 23 (x) as amended by Revenue Act of 1951, sec. 307.

¹¹⁰ I.R.C., sec. 26 (b). Special rules apply to dividends on preferred stock of a public utility and dividends received in property [I.R.C., sec. 26 (h)]. Tax credits for dividends from certain foreign corporations may also be deducted [I.R.C., sec. 26 (b)(3)].

¹¹¹ 49 STAT. 1664 (1936) and Revenue Act of 1936, sec. 26 (b).

more recent income taxes imposed by municipalities constitute a possible exception in that they generally deny the allowance, perhaps justified in the light of the low proportional tax rates and the administrative burdens and constitutional questions avoided by the denial. Both the Kentucky and the federal income taxes make such allowances. The nature and form of such allowances results in important differences between the federal and state income taxes. In the federal law the allowance is in the form of an exemption of \$600 of income per person.¹¹² The Kentucky allowance is in the form of a tax credit.¹¹³ The federal law first subtracts the amount of the exemption from net income and then applies the tax rates. Under the tax credits provisions of the state law, the taxpayer first computes the income tax liability by applying tax rates to the first dollar of net income and then subtracts the allowable tax credits from the tax liability so calculated. The most basic difference between the two forms of allowance results from progressive tax rates. With graduation the effective tax rate applicable to a given taxpayer determines the significance of an income exemption; the income exemption is increasingly significant in terms of tax as income increases. Accordingly, the allowance varies inversely with need. For example, the present \$600 federal exemption provides a tax saving of \$133.20 in the bottom bracket and \$552 in the top bracket. The Kentucky method results in equal tax savings for a given marital or dependency status regardless of income.

Use of income exemptions or tax credits results in shifts in comparative tax burdens according to the size of family units. Compared with income exemptions, tax credits narrow the tax liability differences between different size families. If the law substitutes tax credits for income exemptions tax liability differentials narrow. This is so because tax savings vary with income under income exemptions and remain constant under tax credits.

Another basic difference occurs between the present federal and state method of making allowances. The Kentucky law grants differential allowances for the taxpayer, his spouse, and his dependents. The federal law provides for a per capita income exemption; the amount (\$600 per person) of the allowance does

¹¹² I.R.C., sec. 26 (b).

¹¹³ KY. REV. STAT. 141.060 (1) (1953).

not vary according to the status of the individual giving rise to it. Compared with per capita allowances, differential allowances increase the administrative burden and may also increase tax liabilities.

Differential allowances, compared with per capita allowances may be more closely correlated with the income needs of various size families to maintain comparable welfare.¹¹⁴ That is, compared with savings and diet criteria the per capita allowance "appears to accord relatively too little exemption to single individuals and relatively too much for dependents."¹¹⁵

Although the federal tax allowances are per capita, the law injects an element of differentiation as a result of the special treatment accorded taxpayer or spouse who has attained 65 years of age.¹¹⁶ The federal law allows an additional \$600 exemption if the taxpayer is 65 years of age or more on the close of the taxable year. The federal law makes a similar additional allowance if the taxpayer's spouse is 65 years of age or more on the close of the taxable year. The federal law likewise allows additional \$600 exemptions if the taxpayer or spouse is blind.¹¹⁷ The Kentucky law does not provide additional allowances for cases involving either aged or blind taxpayers or their spouses.

Both laws extend allowances for dependents of the taxpayers. The definition of "dependents" results in further differences. In order that a taxpayer might claim an exemption for a dependent under both laws the dependent must receive over 50 per cent of his support from the taxpayer.¹¹⁸ The federal law specifically denies an exemption for a married individual who has filed a joint return.¹¹⁹ State income tax regulations preclude more than one tax credit per individual and would thereby deny a taxpayer the right to a deduction for an individual that is a party to a joint return.¹²⁰ The Kentucky law specifically denies a deduction if the dependent is 18 years of age or more. It makes an exception for dependents 18 years of age or more that are mentally or physically

¹¹⁴ Division of Tax Research, United States Treasury Department, *Individual Income Tax Exemptions*, (1947), pp. 29 ff.

¹¹⁵ *Id.* at 6.

¹¹⁶ I.R.C., sec. 25 (b)(1) (B).

¹¹⁷ I.R.C., sec. 25 (b)(1) (C).

¹¹⁸ I.R.C., sec. 25 (b)(3) and Ky. REV. STAT. 141.060 (1)(c) (1953).

¹¹⁹ I.R.C., sec. 25 (b)(1) (D).

¹²⁰ *Kentucky Income Tax Regulations*, art. 60-4.

disabled. This is substantially the provision formerly, but not now, used in the federal law.

The federal law denies an exemption for a dependent if the dependent's gross income is \$600 or more even though the taxpayer contributed more than 50 per cent toward the support of the dependent.¹²¹ The Kentucky law provides for somewhat different treatment. The parent or guardian must include as gross income earned income of a minor. Other types of income are taxable to the minor. The state tax regulations specifically deny a deduction for minors required to file a return under article 180-3.¹²² Thus, the state tax law denies the use of an individual with \$1,000 of net income or \$1,500 of gross income exclusive of earned income as a dependent notwithstanding the fact that he received over 50 per cent of his support from the taxpayer.

A change in the status of a dependent is subject to different treatment under the federal and state tax laws. The federal law regards the status of the dependent existing at the close of the taxable year as determining.¹²³ The state law allows a tax credit according to the status maintained six months or more during the taxable year.¹²⁴ Thus, a federal calendar year taxpayer may claim a deduction for a child born in August if otherwise qualified. The state tax allows no credit for such child.

The federal law permits married taxpayers filing a joint federal tax return two \$600 exemptions.¹²⁵ A married taxpayer filing a single federal tax return may take an exemption for his spouse only if the spouse has no income and if no other taxpayer claimed the spouse as a dependent. In the event married taxpayers file two separate federal tax returns, each may claim a \$600 exemption, but the taxpayers may not divide the exemptions on the the two returns in any manner other than in equal proportions of \$600 each. The Kentucky income tax law regards the tax credits allowed married taxpayers in a different manner. The state law regards the tax credit allowed married taxpayers as a "single tax credit for personal exemption."¹²⁶ Married taxpayers filing single

¹²¹ I.R.C., sec. 25 (b)(1) (D).

¹²² *Kentucky Income Tax Regulations*, art. 60-4.

¹²³ I.R.C., sec. 25 (b). In case of death of taxpayer or spouse the status at date of death is determining rather than the status at the close of the taxable year.

¹²⁴ KY. REV. STAT. 141.060 (2) (1953).

¹²⁵ Exemptions may be increased by reason of age or blindness.

¹²⁶ *Kentucky Income Tax Regulations*, art. 60-1.

tax returns may divide tax credits between the two returns in any proportion agreed to by both taxpayers.

Whether the nonresident alien is engaged in a trade or business in the United States, the alien's place of residence and the amount of his gross income influence the size of the exemption allowed for federal tax purposes. The federal law allows no exemptions to nonresident alien taxpayers not engaged in a trade or business if the income from sources in the United States is \$15,400 or less.¹²⁷ The federal law does permit a full \$600 personal exemption if the income is more than \$15,400. Under the federal law a resident of Mexico may take an additional personal exemption for his spouse and exemptions for any dependents if otherwise qualified.¹²⁸ The federal law grants nonresident aliens engaged in a trade or business a personal exemption of \$600. In addition, the federal statute authorizes personal exemptions and exemptions for his spouse and any dependents only if the taxpayer is otherwise qualified and a resident of Canada or Mexico. Although not entirely comparable with nonresident aliens, nonresidents must prorate tax credits for personal and dependency exemptions for Kentucky income tax purposes.¹²⁹ The proportion that the income taxable by Kentucky bears to that taxable under the federal income tax is the basis for apportioning the tax credits deductible for Kentucky income tax purposes. The distinction between federal and state practices of allowing income exemptions or tax credits to nonresident aliens and nonresidents is evident.

ALLOCATION OF INCOME

Taxation of income from sources within a state and excluding such income from without presents an important state income tax problem in view of the interstate character of many corporation activities. This problem is the subject of much consideration by the various states imposing corporation income taxes. A similar problem confronts federal authorities inasmuch as the federal tax is imposed upon nonresident aliens and foreign corporations deriving income from sources within and without the United States. Unlike the states, the problem of allocation of income on the

¹²⁷ *Income Tax Regulations*, 111, secs. 29.214-1 (a) and 29.215-1 (a).

¹²⁸ I.R.C., sec. 214.

¹²⁹ *Kentucky Income Tax Regulations*, art. 60-6.

federal level is considerably less well developed. Provisions of the federal law applicable to this problem are not, generally, of an explicit nature.¹³⁰ With the possible exception of foreign corporations engaged in the transportation business, the general approach by federal authorities appears to be an attempt to utilize the separate accounting technique.¹³¹ In the case of transportation service corporations, the federal law determines income derived partly from within and without the United States by a formula composed of a single "costs or expenses" factor.¹³² The Kentucky law allocates interstate income by formula. The present Kentucky law uses a formula composed of the average of tangible property, sales, and pay roll factors each with equal weight. The Kentucky law does not restrict the formula, as does the federal law, to a single type enterprise. Under the state law, taxpayers may resort to separate accounting only in special cases.¹³³

CREDITS FOR INCOME TAXES PAID TO OTHER JURISDICTIONS¹³⁴

The authority to impose income taxes on the income of citizens or residents regardless of the source from which derived as well as upon all income derived from within the jurisdiction regardless of the residence of the recipient quite frequently results in multiple taxation. Both the federal and Kentucky income tax laws grant relief for those taxpayers who are citizens or residents of one nation or state and derive income from without and for those nonresident taxpayers deriving income from within. The allowance of tax credits for such taxes is the most common device used to alleviate the effects of multiple taxation. Federal remedies involve the use of tax credits and the use of tax treaties with other nations providing for specific exemptions on a reciprocal basis.¹³⁵ The federal law extends tax credits to citizens of the United States

¹³⁰ I.R.C., sec. 119 (c) and *Income Tax Regulations*, 111, secs. 29.119-7 and 29.119-15.

¹³¹ *Income Tax Regulations*, 111, sec. 29.119-12.

¹³² *Id.*, sec. 29.119-13. Although this formula method was originally intended for use by steamship lines it is also applicable to the airline and railway businesses.

¹³³ KY. REV. STAT. 141.120 (1953) and *Kentucky Income Tax Regulations*, art. 120-8.

¹³⁴ Generally this credit is against the tax liability, however the federal taxpayer may choose whether the allowance is to be a credit against the tax or a deduction against income [I.R.C., sec. 131 (a)].

¹³⁵ The federal tax credit is made for taxes imposed upon income or profits by a foreign country or a possession of the United States.

and to resident aliens on a limited basis.¹³⁶ The federal law allows no credit to nonresident aliens for foreign income taxes. The law allows a resident alien the credit only if the country of which he is a citizen allows a similar credit to citizens of the United States.¹³⁷ The federal law allows a tax credit to citizens and qualified resident aliens subject to two limitations. Firstly, the amount allowed for taxes paid to any one country or possession must not exceed the proportion of the tax which the net income from sources within the foreign country or possession bears to the entire net income of the corresponding taxable year. Secondly, the credit for all income taxes of foreign countries and possessions may not exceed the proportion of the tax which the net income from sources within those countries and possessions bears to the entire net income of the corresponding taxable year.¹³⁸ The federal law allows domestic corporations a tax credit not in excess of the proportion of the tax which the corporation's normal tax net income from sources without the United States bears to its entire normal tax net income for the same year.¹³⁹

The tax credit allowed by Kentucky applies only to income taxes paid to other states. The state law denies tax credits for income taxes imposed by foreign countries. Unlike the federal law, the state law does not allow a tax credit to domestic corporations. Both foreign and domestic corporations incur a Kentucky income tax only on income from sources within the state in all but four states; therefore no tax credits for Kentucky corporations are necessary.¹⁴⁰ The state tax law denies resident taxpayers the credit if the other state provides a substantially similar tax credit to nonresidents rather than residents.¹⁴¹ The state law allows nonresident taxpayers the credit only if the other state grants a similar credit to Kentucky resident taxpayers.¹⁴² The state law also allows the credit if the other state

¹³⁶ I.R.C., secs. 131 (a)(1) and 131 (a)(3) and *Income Tax Regulations*, 111, secs. 29.131-1 and 29.131-5.

¹³⁷ See Commerce Clearing House, *Standard Federal Tax Reporter*, (1953) Vol. 4, "Tax Treaties" pp. 28,003 ff. for tax treaties with other nations allowing "similar credits."

¹³⁸ See I.R.C., sec. 131 (b) for the limitation applicable to domestic corporations.

¹³⁹ I.R.C., sec. 131 (b).

¹⁴⁰ Domestic corporations are subject to an income tax on their entire net income in Alabama, Louisiana, Mississippi, and North Carolina.

¹⁴¹ KY. REV. STAT. 141.070 (1) (1953).

¹⁴² KY. REV. STAT. 141.070 (2) (1953).

imposes a tax on incomes of its residents from sources within Kentucky but exempts from taxation income of nonresidents, even though derived from within. When the state grants the tax credit to residents, it is limited to an amount not more than would reduce the net tax liability to an amount less than it would have been had the state ignored the income from the other state.¹⁴³ In the case of a nonresident taxpayer, the amount of the tax credit allowed is "the proportion of the tax so payable by him to the state where he resides that his income subject to . . . [the Kentucky income tax] . . . bears to his entire income upon which the tax so payable to the other state was imposed. . . ."¹⁴⁴ The Kentucky tax law allows no credit for taxes attributable to income that would incur a Kentucky income tax liability but is exempt under the laws of the other state.

The allowance of tax credits depends upon state practices and is not optional for the taxpayer. The Kentucky law calculates the tax credit in such a manner that in those instances where multiple taxation occurs the state with jurisdiction by virtue of residence would impose the tax rather than the state with jurisdiction based on the source of income. The federal law manifests no such motive. The federal and state tax credits differ in that the former are limited to citizens and specified resident aliens whereas the latter apply to both residents and nonresidents. A tax credit is available to domestic corporations under the federal law. Because income of domestic corporations derived from sources outside the state generally incurs no Kentucky income tax, no tax credit is necessary in the state law. State and federal laws authorize the allocation of corporate income according to sources from within and without a jurisdiction in determining the limits of the tax credit allowances. Both the Kentucky and federal acts prescribe separate accounting under specified conditions for purposes of determining income derived from within the taxing jurisdiction. In addition to tax credits, the federal law utilizes tax treaties to minimize the effects of multiple taxation occasioned by the imposition of income taxes upon the same income by different nations.¹⁴⁵

¹⁴³ KY. REV. STAT. 141.070 (1) (1953).

¹⁴⁴ KY. REV. STAT. 141.070 (2) (1953).

¹⁴⁵ I.R.C., sec. 22 (b)(7) authorizes the exclusion from gross income of income exempt by treaties with other nations.

RATES

One of the most significant differences between the federal and state income taxes is the rate structures. Although the federal rates are much higher than the state rates, other differences also exist. The federal income tax rate structure applicable to both corporations and individuals consists of normal and surtax rates. The Kentucky income tax makes no use of normal and surtaxes; rather the law utilizes a flat-rate corporate tax and one graduated series of personal tax rates.

The federal normal and surtaxes applicable to individuals are noted for their high and progressive nature. For the calendar years of 1952 and 1953, the federal law applies marginal tax rates of slightly more than 90 per cent to individuals on incomes from \$100,000 upward, but prescribes an over-all average rate limitation of 88 per cent.¹⁴⁶ Beginning with 1952 calendar year tax returns, the federal law provides for lower rates for taxpayers qualifying as unmarried heads of households.¹⁴⁷ The preferential tax rates represent an attempt to place such taxpayers on a tax level comparable with married taxpayers who are similarly situated and who have access to the income splitting provisions. The federal corporation income tax structure for the calendar years of 1952 to 1954 is composed of a normal tax of 30 per cent and a surtax of 22 per cent, the latter applicable to income in excess of \$25,000.¹⁴⁸ The Kentucky personal income tax rates are graduated from 2 per cent on the first \$3,000 of income to 6 per cent on all income in excess of \$8,000.¹⁴⁹ Corporations are subject to a flat 4.5 per cent state tax rate.¹⁵⁰ The federal and state rate structures are somewhat similar in that the individual tax rates are graduated and corporate tax rates are largely proportional.¹⁵¹ Inasmuch as the Kentucky law contains no income splitting provisions for married taxpayers, the state law provides no preferential rate structure for unmarried heads of households as does the federal law.

¹⁴⁶ I.R.C., sec. 12 (f) as amended by The Revenue Act of 1951, sec. 101 (b).

¹⁴⁷ I.R.C., sec. 12 (c) as amended by The Revenue Act of 1951, sec. 301 (a).

¹⁴⁸ I.R.C., secs. 13 (b) and 15 (b). The surtax rate is increased by 2 percentage points for corporations electing to file consolidated tax returns [I.R.C., sec. 141 (c)].

¹⁴⁹ Ky. REV. STAT. 141.020 (1953).

¹⁵⁰ Ky. REV. STAT. 141.040 (1953).

¹⁵¹ Inasmuch as the federal corporation surtax is applicable to net incomes in excess of \$25,000, an element of graduation is introduced in the federal income tax rate structure.

PAYMENT OF TAXES

In addition to the above aspects of the federal and state income taxes, there are other features resulting in significant differences. The pay-as-you-go or collection at the source is a distinctive feature of the federal income tax. The federal income tax requires employers to withhold portions of wages paid to all employees in accordance with prescribed methods.¹⁵² The federal law also requires certain wage earners and recipients of other types of income to file a declaration of their estimated tax and tender payment of the tax in either a lump sum or in installments.¹⁵³ The federal law also requires withholding on certain tax free covenant bond interest and on payments to nonresident alien individuals, nonresident fiduciaries, nonresident partnerships, and nonresident foreign corporations.¹⁵⁴ Through the operation of the withholding and estimated tax payment features mentioned above, the federal government collects the individual income tax and a relatively insignificant portion of the federal corporation income tax on a current basis.¹⁵⁵ The Kentucky income tax makes only limited use of such devices. Nonresident taxpayers may be subject to withholding of not over 5 per cent of income incurring a state income tax liability.¹⁵⁶ For such taxpayers rents, royalties, and income from employment in excess of \$600 per year are subject to withholding unless waived by the department. A financially responsible payor may avoid withholding under the state law by agreeing to assume any unpaid tax liabilities.¹⁵⁷ The statute provides for information at the source for payments made by corporations and individuals to residents of the state without authorizing withholding.¹⁵⁸ Thus, a most important characteristic of the federal income tax, the current payment of the tax, is almost entirely lacking in the state tax although there is limited authorization for information at the source.

In addition to the regular federal normal and surtaxes there are other special rates applicable in particular circumstances. Fre-

¹⁵² I.R.C., secs. 1621, 1622, and 1632 and *Income Tax Regulations*, 111, sec. 405.

¹⁵³ I.R.C., secs. 58, 59, and 60.

¹⁵⁴ I.R.C., sec. 143 and *Income Tax Regulations*, 111, sec. 29.145.

¹⁵⁵ Nonresident foreign corporations are subject to withholding of taxes applicable to prescribed payments (I.R.C., secs. 143 (b) and 144).

¹⁵⁶ KY. REV. STAT. 141.020 (3) (1953).

¹⁵⁷ *Kentucky Income Tax Regulations*, art. 20-11.

¹⁵⁸ KY. REV. STAT. 141.150 (1953).

quently Congress had added special rates in the nature of a penalty to close loopholes in the federal law.

Significant tax revenue losses from earnings of corporations may occur depending upon whether the corporation distributes such earnings. Earnings of corporations may be subject to the corporation income tax and personal tax upon distribution. The federal law recognizes the possible accumulation of earnings for purposes of tax avoidance and imposes a penalty surtax on such income accumulated beyond the reasonable needs of the corporation.¹⁵⁹ Federal administrators must apply the section 102 surtax largely with referrence to each particular case and therefore this portion of the federal law is quite complex to administer. No comparable Kentucky income tax feature exists. The federal law may decrease the need for such a similar state provision. That is, one might regard the effect of the federal law as a strong stimulus against the unreasonable accumulation of income, and income distributed by corporations is subject to state tax. To the extent that the corporation pays the federal penalty section 102 surtax the state incurs revenue losses due to an unreasonable accumulation of income by corporations. The state method of taxing liquidating dividends is quite inadequate as a deterrent against the unreasonable accumulation of income.¹⁶⁰

The federal law designates certain corporations as personal holding companies.¹⁶¹ In addition to the regular corporation normal and surtaxes, personal holding companies are subject to a special surtax on specified undistributed earnings. Congress enacted the special surtax to close a loophole resulting from the rate differential between individual and corporate taxpayers. The lower corporation tax rates and favorable personal capital gains tax gave rise to the loophole. Individuals with high incomes could otherwise avoid taxes by transferring income-producing property to a corporation. The corporation would accumulate income from such income-producing property which would be subject to the comparatively lower corporate tax, possibly a capital gains tax upon liquidation, or no income tax in the event of death of the owner. An examination of state rates reveals personal and corpo-

¹⁵⁹ I.R.C., sec. 102.

¹⁶⁰ KY. REV. STAT. 141.010 (3) (1953) provides for the taxation of liquidating dividends.

¹⁶¹ I.R.C., secs. 501 ff. and *Income Tax Regulations*, 111, secs. 29.501 ff.

rate rate discrepancies somewhat similar to the federal tax. Federal use of the special personal holding company surtax is apparently a sufficiently strong deterrent to eliminate the use of the personal holding company device as a method of tax avoidance on both the federal and state levels. No special state income tax is applicable to the undistributed income of personal holding companies.

PENALTIES

The federal and state tax laws impose penalties with reference to an act or omission of an act by the taxpayer. Both laws impose penalties of an ad valorem and specific type. Under both laws, failure to file a return not due to reasonable cause or due to willful neglect gives rise to a penalty of 5 per cent of the tax liability for each 30 days of the delay in filing a return.¹⁶² This penalty may not exceed 25 per cent of the tax. If a part of the deficiency is due to negligence without intent to defraud, both state and federal laws impose an additional penalty of 5 per cent of the deficiency.¹⁶³ Any part of the deficiency resulting from fraud with intent to evade either the federal or state tax carries a penalty of 50 per cent of the deficiency.¹⁶⁴ The state and federal laws provide for an interest charge of 6 per cent per year on all unpaid income tax liabilities.¹⁶⁵ A state tax provision authorizes the department to estimate the net or adjusted net income of any taxpayer who fails to file a return or who refuses to furnish any information requested in writing by the department.¹⁶⁶ The department may assess a tax liability of not more than twice the estimated liability and add a penalty of 25 per cent of the deficiency so calculated. Any assessments not paid at the time prescribed and for which no protest is filed result in an additional penalty of 1 per cent per month of the unpaid obligation.¹⁶⁷

In addition to the above civil penalties, both the state and federal laws provide for criminal penalty upon conviction by a court of competent jurisdiction. The Kentucky statute provides for a criminal penalty a fine of \$500 to \$5,000 or imprisonment

¹⁶² I.R.C., sec. 291; *Income Tax Regulations*, 111, sec. 29.291-1; and Ky. Rev. Stat. 141.990 (2) (1953).

¹⁶³ I.R.C., sec. 293 (a) and Ky. Rev. Stat. 141.990 (3) (1953).

¹⁶⁴ I.R.C., sec. 293 (b) and Ky. Rev. Stat. 141.990 (4) (1953).

¹⁶⁵ I.R.C., secs. 292, 294, and 297 and Ky. Rev. Stat. 141.990 (7) (1953).

¹⁶⁶ Ky. Rev. Stat. 141.990 (1) (1953).

¹⁶⁷ Ky. Rev. Stat. 141.990 (7) (1953).

of six months to five years, or both.¹⁶⁸ The federal statute provides for a more detailed classification of criminal penalties and prescribes more severe punishment than does Kentucky.¹⁶⁹

ASSESSMENT OF ADDITIONAL TAXES

Designated state and federal administrative offices are responsible for auditing state and federal income tax returns respectively. Audits may result in calculations of tax liabilities different from those indicated on the return and paid by the taxpayer. Adjustment in the form of refunds or the assessment of additional taxes may ensue.¹⁷⁰ The office of the Director of Internal Revenue makes the assessment of additional federal income taxes as a result of mathematical errors by a correction notice. The federal administrators usually make additional assessments not of a purely mathematical nature by a "30-day letter," indicating the nature of the additional assessment and informing the taxpayer that he has 30 days to file a protest. Three alternatives are available to the taxpayer upon receipt of the "30-day letter." He may accept the deficiency, file a protest, or take no action and await a formal deficiency notice. The formal notice is generally referred to as a "90-day letter." Upon receipt of the "90-day letter" the taxpayer may acknowledge the deficiency,¹⁷¹ contest the deficiency before the Appellate Division, file a petition before the Tax Court, or take no action. Hearings before the Appellate Division generally constitute an exhaustion of the administrative remedies. An appeal to courts independent of the service may follow.

Unlike the federal law, the Kentucky act makes no separate provisions differentiating between mathematical and other errors that give rise to additional assessments. The Kentucky income tax division gives taxpayers notices of additional assessments by mail.¹⁷² Within 30 days from the date of such notice, taxpayers may either tender payment of the deficiency with interest or file a protest and request a hearing before the Division of Income Taxa-

¹⁶⁸ KY. REV. STAT. 141.990 (6) (1953).

¹⁶⁹ See I.R.C., sec. 145 for criminal penalties applicable to the federal income tax.

¹⁷⁰ Refunds are considered separately below.

¹⁷¹ Acknowledgment of the deficiency reduces the interest accruing on the deficiency assessment.

¹⁷² KY. REV. STAT. 141.210 (1) (1953) and *Kentucky Income Tax Regulations*, art. 210-4.

tion. The taxpayer may appeal the decision of the Division of Income Taxation to the Kentucky Tax Commission within 15 days. Having exhausted the administrative remedies, the taxpayer may appeal the decision of the Kentucky Tax Commission on the record to the Franklin Circuit Court within a period of 15 days after final determination.

Federal tax administrators may assess additional federal income taxes within three years after the taxpayer filed the return.¹⁷³ In the event the taxpayer has omitted income in excess of 25 per cent of the gross income federal income tax administrators may make an additional assesment any time within five years. The federal income tax administrators may make additional assessments at any time if the taxpayer failed to file a return or filed a fraudulent return.¹⁷⁴ The corresponding state provision is almost identical with the federal; however the period in which state income tax administrators may make additional state income tax assessments is four years after the taxpayer filed the tax return.¹⁷⁵ If the taxpayer omits from his state return gross income in excess of 25 per cent of the gross income appearing in the return the department may make an additional assessment any time within six years. In the event the taxpayer filed a fradulent return or filed no return, the Department of Revenue may assess such taxes and penalties at any time.

REFUNDS

In contrast to additional assessments are tax payments in excess of the liability necessitating an adjustment by tax refunds or credits against future tax liabilities. Overpayment of taxes may occur for various reasons with the federal withholding scheme giving rise to a large portion of overpayments. Upon filing a return the Internal Revenue Service refunds any excess or at the taxpayer's option credits the excess against any income tax liability of the individual of the next year. Taxpayers exercise their option on the tax return.¹⁷⁶ The federal bureau refunds any excess of estimated tax payments over the actual liability on the basis of

¹⁷³ I.R.C., sec. 275 and *Income Tax Regulations*, 111, sec. 29.275-1.

¹⁷⁴ I.R.C., sec. 276 (a).

¹⁷⁵ KY. REV. STAT. 141.210 (1953) and *Kentucky Income Tax Regulations*, art. 210-4.

¹⁷⁶ *Income Tax Regulations*, 111, sec. 29.322-3.

the individual's tax return. Amended returns may constitute bases for refunds.¹⁷⁷ Taxpayers make formal claims for refunds through the use of Form 843 on which the taxpayer presents data and reasons for the claim. Taxpayers with claims for refunds that are denied and claims upon which the federal bureau has made no decision within six months after date of filing may file suit to recover such taxes. The taxpayer must take such action within two years after the date of posting the notice of disallowance. The federal law provides special procedures for refunds of overpayments due to carry backs of operating losses or excess profits tax credits. In order that either the commissioner or taxpayer might not secure a double advantage by operation of the statute of limitations, stemming from a deficiency or refund claim, the code mitigates the limitation and provides for an adjustment in which the entire tax liability is considered.

The absence of extensive use of withholding and of estimates tax features in the state law decreases the need for refunds. Excessive tax payments may result from mathematical errors on the original return and on erroneous interpretation of the law. The Department of Revenue makes refunds of state income taxes withheld for nonresident taxpayers on the basis of the return.¹⁷⁸ Claims for refunds of state income taxes must contain prescribed data together with a recital of the reasons for the claim in a manner quite similar to the federal law.¹⁷⁹ Although usually unnecessary, amended returns must accompany the claim in those cases in which the taxpayer has made errors of fact in the original return or if requested by the department. Taxpayers may appeal claims for refunds that are denied by the division to the Kentucky Tax Commission in the same manner as additional assessments. As in the case of additional assessments, the taxpayer must exhaust the prescribed administrative remedies before resorting to the courts. Taxpayers must initiate claims for refunds of excessive state income taxes within four years after paying the money into the state treasury.¹⁸⁰

¹⁷⁷ *Ibid.*

¹⁷⁸ KY. REV. STAT. 141.020 (1953) and *Kentucky Income Tax Regulations*, art. 20-13.

¹⁷⁹ *Kentucky Income Tax Regulations*, art. 235-1.

¹⁸⁰ KY. REV. STAT. 141.235 (1953).