ADDITIONAL AUDIT TECHNIQUES AND PRACTICAL TIPS

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ADDITIONAL AUDIT TECHNIQUES AND PRACTICAL TIPS

INTRODUCTION

An audit should usually be started only after proper audit assignment folders have been received.

BEFORE BEGINNING THE AUDIT FIELD WORK

Review last audit of taxpayer (if applicable) to determine the period this audit will cover. If there has not been a prior audit of the taxpayer, review return due date and filing dates to establish periods open for audit. The audit period can be longer than four years if the taxpayer is an annual, quarterly or non-filer for part of the audit period.

Review audit transmittal letter listing reasons why audit was assigned and possible adjustments that may be made. Particular interest should be paid to the comments listed on the audit transmittal sheet.

Read the last audit narrative to become familiar with the taxpayer's business activities, adjustments made in the prior audit, and possible problem areas that need to be addressed. By reviewing the prior audit file the auditor will become aware of possible adjustments that may be made in the current audit, and areas that were extensively examined in the prior audit and yielded no adjustments. Areas that were extensively examined in a prior audit and yielded few adjustments may not need to be examined as extensively in the current audit. Since changes occur from year to year be aware that areas in which no adjustment was made in a prior audit are not automatically correct in the current audit period. The prior audit folder should be used as a guide, not a shortcut, for completing the current audit.

Prepare a list of questions to ask the taxpayer's representative during initial contact and begin filling out the Electronic Data Questionnaire. Some of the pertinent questions that may be asked are questions such as location of the taxpayer's operations with specific emphasis on the Kentucky operations, whether or not the taxpayer has had any large capital projects since the last audit, and any major operation or personnel changes since the last audit. Also, during initial contact with the taxpayer’s representative it is necessary to determine if electronic records are available.

Review information on the sales and use tax databases for use tax accruals, type of deductions taken, reported receipts and tax paid.

Review SUITS to see if taxpayer has refund requests outstanding and/or paid under amnesty. Get a copy of all available annual sales tax summaries for SU-Annual on KREW. It may be helpful in some circumstances to have an audit supervisor obtain copies of federal or state income tax returns from the Corporate Coding system or ELF system.

Prepare a waiver, if necessary. Make sure that the waiver covers enough periods so that proper time will be allowed to process the audit.

Contact taxpayer representative to set date and time to start the audit. This initial contact with the taxpayer is usually done by telephone. During the conversation continue filling out the Electronic Data Question to determine the availability of electronic data. If electronic data is not available discuss and agree upon test periods that will be used for the audit. The test period should be large enough to reflect the taxpayer's activity for the entire audit. Assess the possible need to take special forms such as the Contractors Agreement, Subcontractors report, nexus questionnaire, and application for non-filer. Determine from the taxpayer's representative the taxpayer's business locations everywhere, in Kentucky, any changes in business locations since the last audit, large expansion projects and a general overview of the taxpayer's business operations. Try to find out if taxpayer has any unusual circumstances that impact the audit such as bankruptcy filings. If a manufacturer, find out if taxpayer has applied for or is filing energy direct pay returns. Determine if the taxpayer has unregistered divisions which make sales into Kentucky.

Prepare and mail confirmation letter to taxpayer. This confirmation letter should contain the following information:

- Date and time that the audit is scheduled to start.
- Number of auditors performing the audit.
- The periods that the audit will cover.
- A list of the records that will be needed to complete the audit.
- Areas that the audit will cover including an explanation of the areas that will be audited on a test basis and the areas that will be audited on an actual basis. If electronic data is available note the areas for which this method will be used. If electronic data is not available, the test periods chosen using a block sample should be listed.
- Exchange agreement forms, SEATA brochure **(Form 31F006)**, Kentucky's Computer Assisted Audit Program brochure **(Form 31F010)**, **Form 62A500-L – <u>Tangible Personal Property Tax Compliance Return for Lessee</u>** and the Kentucky Taxpayer Bill of Rights may also be included with the confirmation letter along with necessary waivers.

<u>INITIAL CONFERENCE AT THE TAXPAYER'S PLACE OF BUSINESS</u>

Before actually starting the field work it is a good idea to have the taxpayer's representative explain the preparation of a sales and use tax return. Special emphasis should be placed on determining the source of the figures used to compile the return.

If applicable, obtain copies of the taxpayer's annual report and **Form 10-K.** These may be available on the internet. Review these documents before starting audit field work. These documents will be very helpful in becoming familiar with the taxpayer's operations, and in writing the audit narrative.

Examine the records provided by the taxpayer's representative to make sure that the records are all-inclusive of those listed in the confirmation letter. If the records are incomplete inform the taxpayer's representative of the missing records immediately.

If the taxpayer is a manufacturer, a plant tour before starting the audit is often helpful. Areas that would qualify for exemption may be determined before the actual field work begins.

STARTING THE AUDIT FIELD WORK

Sales

Reconcile the sales reported by the taxpayer on the sales and use tax returns to the amounts reflected on the income tax return or general ledger. If these amounts are different this difference should be reconciled and explained in the audit narrative. Determine source and possible taxability of any unreported receipts of the taxpayer. Some sources of possible unreported receipts would include asset sales, scrap sales, and employee sales.

Trace amounts listed as sales tax collected from the general ledger to amounts actually reported on the taxpayer's sales and use tax returns.

Verify that all sales invoices for the test period have been made available for review. If the taxpayer's sales invoices are filed numerically account for the numerical sequence of the invoices for the test period. If the taxpayer's sales invoices are filed by a method other than numerically trace a reasonable number of the sales invoices from the sales journal to the actual invoices furnished by the taxpayer.

Verify assets sales on **Form 4797 – Sales of Business Property** and determine if the taxpayer has treated such assets sales correctly.

Deductions

If electronic records are available and the audit population is sufficient it may be necessary to have a random sample drawn for the examination of the taxpayer’s deductions. If electronic records are not available a test period may need to be determined. Certain conditions must be present before it is appropriate to use a test period. Some of the factors that the auditor must use to determine whether or not auditing on a test basis is appropriate are whether or not the taxpayer's amounts of claimed deductions are uniform as to size and distribution throughout the entire audit period, the basic characteristics of the business and that the method of reporting remained the same throughout the audit period. If the basic characteristics and reporting methods change during the audit, the auditor must consider the necessity of multiple test periods. Special care must also be exercised by the auditor to ensure that any test periods used contain sufficient items to make the test fairly reflective of transactions for the entire audit period. Also assess whether or not law changes (such as the expiration of the enterprise zone) should be taken into account in the test in order to accurately reflect any tax liability found.

Deductions for sales in interstate commerce may be verified by utilization of such records as bills of lading, customer purchase orders, delivery logs, and UPS bills. These records can be compared to the actual sales invoices to verify that the merchandise was actually shipped out-of-state if it is suspected that there may be a problem in this area.

If the taxpayer is taking deductions for bad debts it is necessary to verify that the taxpayer is an accrual basis taxpayer and that any deduction taken for bad debts on the sales and use tax returns has been deducted on the taxpayer's Federal Income Tax Return. Confirmation should also be made that any bad debt deduction taken relates to a sale on which tax was originally charged and reported. Any bad debts that have previously been written off and deducted for sales tax purposes should be reported if payment is received.

Sales for resale that have been deducted by the taxpayer should be verified by making sure that the taxpayer is in possession of a properly completed resale certificate for the sale in question. This resale certificate should state the item that the purchaser is buying for resale. If the taxpayer's file of resale certificates contains a large number of blanket certificates covering a wide range of products, the acceptance of these certificates in good faith may be an issue in determining their acceptability.

On deductions for returned merchandise, verification should be made that tax had been charged on the original invoice and remitted by the taxpayer.

Deductions for sales to exempt organizations must be verified by reviewing the taxpayer's file of exemption certificates. Good faith as far as exemption certificates are concerned is different than with resale certificates.

Purchases

If electronic records are available and the audit population is significant, it may be necessary to have a random sample drawn for the examination of the taxpayer’s expenses. If electronic records are not available a test period may need to be determined. Since the test period has been previously agreed upon by the auditor and the taxpayer, this area should be reviewed to see that the area examined was not seasonal or distorted but represents an accurate account of the entire business operations.

Capital asset additions are generally examined on an actual basis for the entire audit period whether or not the records are available electronically. The major document used in this area to ensure that all capital asset invoices have been made available for the auditors review is the taxpayer's depreciation schedule and appropriations for expenditures.

Accrual Accounts

Audit history has shown that taxpayers, at times, will accrue tax, but not necessarily remit same to the Department.

Accordingly, all audit narratives should contain a statement as to the amounts currently on the accrual of each taxpayer for both sales tax and income tax. In addition, a schedule should be prepared showing the dates of entries that make up the accrual balance and the reason why each entry was made.

Determine if major changes have occurred in the taxpayer's organization, such as adding departments or reorganizing cost centers, and ensure that the taxpayer's accrual system has been properly changed.

Retailer's Claim that Tax has been Paid by Purchaser

In those situations where resale certificates have been disallowed and the retailer claims that the purchaser has paid the use tax directly to the Department, the field auditor will be requested to obtain from the retailer a notarized affidavit signed by the purchaser (owner, partner or officer) stating that it has paid such tax on its sales and use tax return or through audit by the Department. In the case of a payment on a return, this information will be considered as satisfactory evidence of payment of the tax both in the Division of Field Operations and in the Division of Audit Review and Protest Resolution unless there is evidence that the contents of the affidavit are incorrect. In the case of a payment through audit, the sale will only be deleted from the vendor's audit upon verification through the Division of Audit Review and Protest Resolution that the contents of the affidavit are correct. In addition, if the vendor does not have a resale certificate on file from the purchaser, the purchaser must include in the affidavit a statement that it will not seek a refund from the Department on the basis that the tax was the vendor's liability. Copies of all such affidavits are to be included in the audit file.

Specifically, the affidavit should contain the following statement:

> I declare under penalties of perjury, that the statements contained in the affidavit are to the best of my knowledge and belief true and correct. Should it be determined upon audit that this affidavit is not correct, I agree to accept liability for the sales and use tax on purchases from ___(Vendor's Name)___.

The affidavit must be signed by the owner of the business or by an officer and submitted with the audit.

CHECKS RECEIVED BY AUDITORS

Taxpayers should be encouraged to remit payment on an audit even before the audit has left the service center.

Accordingly, whenever a check is received for a proposed audit assessment, the auditor must attach **Form 31A004 – Auditor Record of Money Receipt Issued.** This form is used by Accounts to identify the liability as an unbilled audit assessment. Audit Review also uses the form to establish the billing. Also, be sure that the type tax, account, and audit assignment number are filled in on the form. Obtain supervisor's initials on **Form 31A004** before it, and attached check are forwarded.

It is necessary to attach a copy of the recap sheet from the audit workpapers to **Form 31A004** when a collection is made on an audit in the field and the payment is submitted without the audit folder.

The payment received does not finalize the audit as it is still subject to review by Audit Review and Protest Resolution. Payment does stop interest from accruing, but does not toll the statutes.

CANCELLATION OF AUDIT VS. NO CHANGE

The fact that some time has been charged to an audit does not prevent it from being submitted as a cancellation. If an auditor has done research on the file and has determined that the audit is not worth pursuing, it should be submitted as a cancellation. If the auditor has simply discussed some aspects of the audit with the taxpayer but has not reviewed any books or records, the audit still should be submitted as a cancellation.

Any time an auditor has reviewed records of the taxpayer and it is determined, from this review that the audit is not worth pursuing, the audit should be submitted as a no change. The fact the auditor did not review all records or did not prepare any schedules does not alter this situation. Whenever an auditor actually reviews a taxpayer's records to determine that the audit is not worth pursuing, such taxpayer is entitled to a no change audit. All no change audits are to contain an audit report and narrative.

Other Situations – Multiple Taxes

The entity was registered for one or more taxes but the entity no longer exists. An audit would be done on any periods in which they were operating and which are open for audit. However, if there were no operations in open periods the audit will be submitted as a cancellation.

Other Situations - NEXUS

In situations in which the auditor has reviewed the records of an entity to make a nexus determination, the assignment will be a completion. If records have not been reviewed and the only information the auditor has received is the **Nexus Questionnaire** or similar information no audit has been performed and the assignment should be submitted as a cancellation.

If the entity has a Kentucky account number for the tax in question the audit will be done to determine the proper tax liability and to issue any refund due.

If the entity has registered, has never filed any returns, does not have nexus with Kentucky and no records were reviewed, the assignment would be submitted as a cancellation.

If the entity has never been registered for Kentucky taxes and the auditor determines that the entity does not have nexus for Kentucky, but does so without a review of the records of the entity, the assignment will be submitted as a cancellation.

When a corporation files as part of a consolidated group, an audit of the group will involve an examination of the records of all corporations included in the consolidated return. This review does not constitute an audit of each corporation. Any examination of a corporation that is part of a consolidated group only because it is part of that group return will not be considered a review for nexus determination.

For all audits, both cancelled and completed, there must be a written explanation of the reasons why it was determined that the entity does not have nexus for Kentucky and the steps taken to make the determination. If applicable, include the reason for registration, including why it was originally decided that they had nexus for Kentucky. For an assignment submitted as a completion, this information goes in the narrative. For cancellations, the information goes in a memo for the record. In all cases the completed **Nexus Questionnaire** or other information received must be included in the audit folder.

For audits submitted as completions, the narrative should request the cancellation of the account number by the Division of Protest Resolution once the audit has been processed. For audits submitted for cancellation, the tax account number will be cancelled by the Audit Supervisor at the time the audit is returned for cancellation. In each situation, the individual responsible for the cancellation of the tax account number will notify the entity's representative of the determination that nexus does not exist and ask that they request the cancellation of the tax account number.

LETTERS WRITTEN BY AUDITORS

It is realized that auditors must communicate with taxpayers via letters. However, it is emphasized that the wording of letters should be such that they do not give the taxpayer the impression that the audit schedules are final. In letters to taxpayers dealing with adjustments it should be emphasized that the adjustments will be subject to review by the Division of Audit Review and Protest Resolution. Letters to taxpayers should also avoid any verbiage that any penalties to which the taxpayer is subject are being waived. No letters should be sent to taxpayers by auditors without the audit supervisor having knowledge of its contents.

CORRESPONDENCE – TECHNICAL ASSISTANCE

The Office of Field Operations will answer letters received in the service centers from taxpayers via regular mail or e-mail rather than forwarding them to Frankfort for reply. If a taxpayer utilizes e-mail seeking a ruling, it is permissible to respond via e-mail. It is realized that there will be cases where the service center should not respond to the taxpayer's letter. Such cases will be decided on a case by case basis in consultation with your regional manager.

If the taxpayer wants written confirmation of information that you have provided, the request is to be directed to the service center.

The following procedure will be used in replying to taxpayer's correspondence:

- Note on the letter the date received. Use a date stamp if the service center has one.
- The letter will be entered into the correspondence log, which is an Excel file.
- The district manager will assign the letter for a reply to be drafted. **NOTE:** regardless of who actually writes the reply, the letter will be signed by either the district manager or audit supervisor.
- The reply must be submitted to your regional manager for review before being sent to the taxpayer.
- After approval by the regional manager, make appropriate entries in correspondence log.
- Send the original of the reply to the taxpayer and a copy of the reply attached to taxpayer's original letter to the Central office for filing in the taxpayer's historical file.

The format of the letters should be:

Taxpayers Name and Address
RE: (Type tax and account number)
Salutation
First paragraph – acknowledge receipt of the inquiry and restate the taxpayer's question
Following paragraphs – state statutes and/or regulations applicable to taxpayer's question. NEVER refer to a circular or tax policy. State answer to taxpayer's question.
Closing paragraph
Signature block

A TECH LETTER LIBRARY folder has been set up on the server under the COMMON FOLDER. Path is: revof2san1\users\field division\common folder\Tech Letter Library

The folders are under this folder will be set up subject under tax type. The library folders will be updated as needed. Please review some of the letters in these folders to become familiar with the above format. The documents are Microsoft Word files.

A Correspondence Log will be maintained at each service center.

CORRESPONDENCE – OUT-OF-STATE AUDIT

It is expected and the responsibility of each auditor to make a good faith effort to secure all the information necessary to complete the audit while at the taxpayer's place of business. However, it is recognized that it is most difficult to complete an out-of-state audit while at the audit site. This necessitates leaving the audit site without all the needed information, and leaving the taxpayer with a list of items necessary to complete the audit. Historically, when this situation has developed, the taxpayer is not as responsive to our needs.

In an attempt to alleviate this problem as much as possible, it is standard audit procedure for the auditor to write the taxpayer a letter upon his/her return from the trip reiterating what information is needed and to establish a reasonable time frame to receive such information.

It is the Audit Supervisor's responsibility to see that the letter is written to the taxpayer no later than Friday of the first week back from the trip.

ESTIMATED AND JEOPARDY ASSESSMENTS

KRS 131.150 – Jeopardy Assessments

(1) When the Department of Revenue reasonably believes that any taxpayer has withdrawn from the state or concealed his assets or a material part thereof so as to hinder or evade the assessment or collection of taxes, or has desisted from any taxable activity in the state, or has become domiciled elsewhere, or has departed from this state with fraudulent intent to hinder or evade the assessment or collection of taxes, or has done any other act tending to render partly or wholly ineffective proceedings to assess or collect any such taxes, or contemplates doing any of these acts in the immediate future, or that any tax claim for any other reason is being endangered, such tax liability shall become due and payable immediately upon assessment or determination of the amount of taxes due, as authorized in this section.

(2) Under any of the circumstances set out in subsection (1) of this section, the department may make a tentative assessment or determination of the taxes due, and may proceed immediately to bring garnishment, attachment or any other legal proceedings to collect the taxes so assessed or determined to be due. Notwithstanding the provisions of **KRS 131.180(1)**, if the tax so assessed is due to the failure of the taxpayer to file a required tax return a minimum penalty of one hundred dollars ($100) shall be assessed unless the taxpayer demonstrates that the failure to file was due to reasonable cause as defined in **KRS 131.010(9)**. This penalty shall be applicable whether or not any tax is determined to be due on a subsequently filed return or if the subsequently filed return results in a refund. No bond shall be required of the department in such proceedings. The taxpayer may stay legal proceedings by filing a bond in an amount sufficient in the opinion of the department to cover the taxes, penalties, interest, and costs. If no legal proceedings have been instituted, the department may require a bond adequate to cover all taxes, penalties, and interest. On making bond, exception to the assessment or determination of tax liability may be filed in the same manner and time as provided in **KRS 131.110**. If no exceptions are filed to the tentative assessment or determination, it shall become final.

(3) The department may require any such taxpayer to file with it forthwith the reports required by law or regulation, or any additional reports or other information necessary to assess the property or determine the amount of tax due.

(4) If the department fails to exercise the authority conferred by this section, such taxpayer shall report and pay all taxes due as otherwise provided by law.

Effective: June 20, 2005

History: Amended 2005 Ky. Acts ch. 85, sec. 116, effective June 20, 2005. -- Amended 2002 Ky. Acts ch. 366, sec. 13, effective January 1, 2003. -- Amended 1964 Ky. Acts ch. 141, sec. 39. -- Recodified 1942 Ky. Acts ch. 208, sec. 1, effective October 1, 1942, from Ky. Stat. sec. 4114h-9.

KRS 131.180(4) is the statutory authority for issuing an **Estimated Assessment** and **KRS 131.150** is the statutory authority for issuing a **Jeopardy Assessment**. These types of assessments are utilized in cases that taxpayers fail to cooperate by providing adequate records to perform audits. An Estimated Assessment is the normal course of action while a Jeopardy Assessment is used in situations such as when the Department reasonably believes that the taxpayer has withdrawn from the state or concealed his assets or a material part thereof so as to hinder or evade the assessment or collection of taxes. **Once it is determined one of these measures is necessary, adhere to the following guidelines:**

Guidelines:

Send at least two letters. **(Does not include initial correspondence scheduling the audit.)**

- The first letter should be specific, identifying types of records needed and the date the records are needed by and documenting prior actions requesting information. Advise that failure to respond by the requested date without reasonable cause could result in an estimated assessment issued pursuant to **KRS 131.180(4)** or a jeopardy assessment pursuant to **KRS 131.150**.

- Give the taxpayer a deadline. Be reasonable, 30-day period is normally suitable. Be sure to monitor so appropriate action can be taken within a reasonable time at the expiration of the time frame given.

- Mail the second letter certified, return receipt requested (if necessary personally deliver). Be specific about records needed, list prior contacts, and provide a date that failure to respond will result in an estimate/jeopardy assessment. Cite the statute and amount of assessment. Give the taxpayer a 10-15 day deadline. Complete audit within two weeks of the deadline if taxpayer fails to respond.

- Include in the second letter a recap, by billing period, of the proposed assessment. Also, send a copy of the Taxpayer Bill of Rights.

- Include the return receipt in the audit folder.

- Audit working papers submitted for billing must reflect your calculations and estimates should be reasonable.

- **KRS 131.180(4)** states '. . .the cabinet may make an estimate of the tax due from any information in its possession, assess the tax at not more than twice the amount estimated to be due. . ." Department procedure is to assess the tax at **twice** the estimate.

- The narrative must explain why the **Estimated/Jeopardy assessments** are recommended, the statutory cite and how the assessments were calculated. The auditor must document her/his actions during the audit, e.g., dates letters sent, dates of other contacts with taxpayers, synopsis of conversations, taxpayer comments, etc. Include copies of correspondence and contact log (if maintained) in audit folder.

– Submit the **"Request for Issuance of Estimated/Jeopardy Assessment"** form.

– Submit a **"Special Handling Notice (31A148)"** form.

PROCEDURES FOR BILLING FIELD AUDITS/REFUND CRITERIA

Definition of Field Audit Billing: Assessment or refund determinations resulting from adjustments proposed by the Division of Field Operations. Assessments are transacted on CARS while refunds will be processed, via applicable refund systems. Assessment and refund actions shall include applicable interest and penalties when appropriate.

Practice: Field Audit work papers are reviewed for technical correctness and consistency with recent policy/legal recommendations. Field Audit reviews result in an assessment, a refund or re-assignment to the Field Division.

Procedure: After review of all taxable periods in the Field Audit work papers, if the audit assessment results in a net tax assessment of less that $100.00, or a net tax refund of less than $50.00, the audit will not be billed/refunded. If the net tax assessment is equal to or greater than $100.00, or the net tax refund is equal to or greater than $50.00, all taxable periods within the audit will be billed/refunded. If tax overpayments exist for some periods and tax assessments for others, tax assessments and tax overpayments for all taxable periods shall be combined to determine the **net tax** threshold. In no instance will the Department issue a refund for less than $50.00 unless specifically requested by the taxpayer in writing.

NOTE: INTEREST WILL BE CALCULATED FOR MEETING THE ABOVE THRESHOLDS ON LARGE DOLLAR CASES. ALSO, MINIMUM BILLING THRESHOLDS WILL NOT APPLY TO NON-FILER AUDIT CASES.

Examples: The following examples are provided:

	Audit Pd	Audit Pd	Audit Pd	Audit Pd	Net Tax Value
1.	$18	$21	$40	$52	$131.00
	Net assessment is over $100, each period will be billed.				
2.	$20	($15)	$40	$30	$ 75.00
	Net assessment is under $100, this will not be billed.				
3.	$50	($40)	$45	$45	$100.00
	Net assessment is equal to $100, each period will be billed.				
4.	$25	($20)	$49	$49	$103.00
	Net assessment is over $100, each period will be billed.				
5.	($25)	($25)	($25)	$150	$ 75.00
	Net assessment is under $100, this will not be billed.				
6.	$10	($25)	$160	($190)	($ 45.00)
	Net overpayment is under $50, this will not be refunded.				

Key Terms:

Net tax assessment shall mean the combined total of all tax assessments and/or tax overpayments proposed for all audit periods.

AUDIT MATERIALITY

In considering materiality in auditing, there are some things an auditor should do to reduce wasted time on audit procedures that can't result in material adjustments.

– **Do your homework** – Before even starting an audit, some time should be spent reviewing the audit folder and information enclosed. Depending on type of tax audit, know the law and regulations that pertain to taxpayer's business and activity. Determine what areas may be subject to errors.

– **Listen to T/P** – Don't be in a hurry to start looking at records and writing information down. Spend time talking with the taxpayer.

– **Be observant –** Decide what is the best and quickest route to pursue to get done what you feel needs auditing. This can always be changed after getting started. Use all of your information drawing areas to help you make this decision.

– **Audit Method –** The type of business and its activity will dictate the method of audit. That is, detail, test, purchase markup, etc. Don't spend time on an audit method that isn't necessary. A random or spot check of certain areas could help you decide what route to follow. A little time spent doing these things could save a lot of time later.

In summary, if the audit staff is going to operate in an efficient and professional manner, we must be constantly aware of audit materiality. The decision of materiality is the auditors' and it must be made wisely. It is not proper for the Department to waste time and money, either ours or the taxpayers, and that in a nutshell is what materiality is all about.

ALLOWABLE BILLING PERIOD

Recognize that the billing system can handle fiscal year ending periods in relation to the interest calculation. Accordingly, billing sheets where applicable are to be prepared on a fiscal year basis. The period for the billing sheet will be the same as that utilized by the taxpayer for filing income tax returns.

GOODWILL REPAIRS

A goodwill repair is the repair of a customer's vehicle at no charge to the customer after the original warranty on the vehicle has expired. Information has been received from other states that substantial audit adjustments have been made in this area. Accordingly, auditors are to review this area during audits of car dealers and manufacturers.

Four situations have been identified relating to goodwill repairs:

– The car manufacturer sends the repair parts to the dealer for use in performing the repair.

  In this situation, the car manufacturer is the consumer of the repair parts used in performing the repair. The car manufacturer would be liable for tax based on the purchase price of the parts or the raw material content if he manufactured the parts used.

– The dealer takes the repair parts from his inventory and is reimbursed by the car manufacturer.

  The dealer is making a retail sale to the car manufacturer of the repair parts. Accordingly, the dealer would apply and collect tax based on the charge for the repair parts to the manufacturer provided the charges for the parts and installation labor are separately stated. If the charges were not separately stated, tax would apply to the total charge.

– The dealer takes the repair parts from his inventory and the manufacturer replaces the parts for the dealer.

  The car manufacturer is providing the repair parts used. As noted above, the car manufacturer is the consumer of the repair parts used in performing the repair. The car manufacturer would be liable for tax based on the purchase price of the parts or the raw material content if he manufactured the parts used.

– The car dealer performs the repair of the vehicle and receives no reimbursement from the customer or the manufacturer.

  In this situation, the car dealer is the consumer of the repair parts used in performing the repair. Tax would apply to the dealer's purchase price of the parts.

GOODWILL REPAIRS – RECALLS

A repair made under a recall of the vehicle is a type of goodwill repair.

Repairs made pursuant to a recall will be treated as a warranty repair even if the warranty period has expired.

SALES & USE TAX REFUND AUDITS

The provisions of **KRS 139.770(4) – Refund or credit of Taxes Paid - Claims** and **KRS 139.570 – Withholding Taxpayer's Collection Costs** need to be applied in audits resulting in a refund. Taxpayers submitting a refund claim should also recognize the provision.

In performing audits that include a refund claim submitted by the taxpayer, it will have to be determined if the taxpayer reduced the refund claim as required by the provisions of **KRS 139.770(4).** If the taxpayer previously deducted the compensation, this amount cannot be claimed again by the taxpayer in the refund of taxes for the periods in question. The Kentucky Department of Revenue is required by statute to adjust any refund or credit claims by the amount of compensation claimed at the time the tax was paid.

All audits resulting in a net refund must have the refund reduced by the compensation as required in the provisions of **KRS 139.770(4).** In situations where there are periods of refund and periods of assessments, only the net refund would be reduced by the compensation.

It should be recognized in audits of taxpayers that have filed a claim for refund and the refund is reduced through audit, the reduction in refund will still be reflected as an assessment in the audit tracking system.

To give an example, a taxpayer files a claim for refund for $100,000. The audit of the taxpayers' record reduced the refund claim by $20,000. The results of the audit would reflect a $20,000 assessment, but in reality, the taxpayer will receive an $80,000 refund. In this situation it was

verified that the refund claim of $100,000 had been reduced by the taxpayer as required by the provisions of **KRS 139.770(4).** If the taxpayer had not reduced the refund claim as required by **KRS 139.770(4),** the auditor would have made the adjustment to the net refund of $80,000. The assessment amount reflected on the audit would have been increased and the refund to the taxpayer would have been decreased by the amount of compensation claimed on the original return.

In performing audits that have a refund claim filed by the taxpayer, it is best to do two Report of Audit schedules. One for the refund claim and one for other audit areas that is not part of the refund claim. In preparing the Report of Audit schedule for the refund claim, if the taxpayer is required to reduce the refund claim by the provisions of **KRS 139.770(4)** and has not, that reduction should be reflected on Line 9 of this schedule. Then do a recap schedule of the two separate Report of Audit schedules. The narrative must explain what was done and why.

ADJUSTMENT AFTER TAX BILL PROTESTED

There are cases where the taxpayer has protested an audit (tax bill sent), the audit has been reassigned and on the return trip an audit adjustment missed in the initial audit is uncovered. Depending on the time frame involved, adjustments can be made for the entire audit period, part of the audit period or not at all.

Consider the following:

For any time frames that are now closed, the Department is limited to the amount that was billed the first time. However, adjustments can be made as long as the original assessment is not exceeded.

For any time frames that are open, the Department is not limited to what was billed the first time. The Department has the right to make any adjustment(s) necessary in order that the audit be correct.

This position is pursuant to the provisions of **KRS 134.580, 131.110(1),** and *Revenue Cabinet, Com. of Ky. v. Castleton, Inc., Ky. App., 826 S.W. 2nd 334 (1992).* In this court case, a claim for refund or credit may be made for an assessment paid after protest by the taxpayer and issuance of a final ruling by the Kentucky Department of Revenue. The assessing area that issued the original assessment shall review the claim for refund or credit. However, under **KRS 131.110(1)** and the principles of res judicata and collateral estoppedl, the Department will not review a claim for refund or credit resulting from a paid assessment for which a petition on appeal has previously been filed by a taxpayer with the KBTA.

Tax Tip: Timely filed refund claims, if the statutes have subsequently expired, can still be offset with other adjustments within the reporting period, but not below zero.

AGENTS' NARRATIVE REPORT

Format of Agents' Narrative Report (Sales and Use Taxes) is shown on the following 3 pages.

The narrative must address the position of the taxpayer. The auditor should limit his/her comments to stating whether the taxpayer agrees with the findings of the auditor, to what extent, or other concerns that he has with the results of the audit. Never include comments on how the taxpayer behaved or how he treated the auditor. The imposition of penalties is based on what the taxpayer failed to do in reporting and paying tax, not on the way he behaved, etc. The Department does not want personnel in Audit Review unduly influenced by comments relative to the taxpayer's behavior. The revealing of such comments in a court of law could be used by the taxpayer in persuading the court that the penalties and possibly even the assessments were levied for other than statutory reasons.

Note #1: It is imperative that the narrative be complete concerning the specifics of the audit. This includes audit procedures used; test periods, stratified random sampling or actual examination; adjustments to be made or information verified as correctly filed, etc. Narratives should always be thoroughly reviewed for both spelling and grammatical accuracy.

Note #2: **A**ll narratives should contain a header. This header should begin on Page 2 and appear as follows:

(Audit Name)
Audit Narrative Report
Page 2

A blank line is to be inserted after the page number by pressing the "enter" key. Setting up a header on the second page with the page numbering code will cause the header to print on the second and all succeeding pages with the appropriate page numbers.

AGENTS' NARRATIVE REPORT

(Sales/Use Taxes)

SUBJECT:	Name, Address, Telephone Number of Taxpayer
TAXPAYER'S REPRESENTATIVE:	Name, Current Title and/or Position, Address, Telephone Number of Taxpayer's Representative
AUDIT TYPE:	Tax(es) Audited and Account Number(s)
PERIODS EXAMINED:	Calendar or Fiscal Years Audited
PERIODS HELD OPEN BY WAIVER:	Also, Indicate When Earliest Period Will Expire
DATE OF AUDIT:	Date Field Examination Started and Date Audit Completed
LEAD AUDITOR:	Name of Lead Auditor Performing Audit
ASSISTING AUDITOR:	Name(s) of Assisting Auditor(s)
REVIEW OFFICER:	(Leave Blank)

I. Taxpayers' Bill of Rights

A. Date and to Whom "Your Rights as a Kentucky Taxpayer" Brochure Provided
B. Audio Recording Made
Address Only if One Made

II. Introduction and Description

A. History of Business
B. Type of Business (Overall Operations)
C. Operations in Kentucky (Identify Each Location and Activity Conducted at Each Location)

III. Scope of Examination, Areas Examined and Proposed Adjustments and Citing the Applicable Kentucky Revised Statute(s) and/or Regulation(s). Identify the applicable schedule(s) where the adjustment was made. Describe the method of audit (test vs. detail) and the records available and examined and conditions of such records. Items not adjusted should be noted, stating that the items have been verified and how each was verified.

A. Gross Sales
B. Deductions
C. Purchases

1. Consumables
2. Capital

D. Energy
E. Other

IV. Agreements

A. Address Indiana/Ohio Agreement
B. Address SEATA Agreement
C. Address Any Agreement Taxpayer Has With Kentucky
D. Address Any Agreement Taxpayer Has, Not Covered Above, That Has an Affect on Kentucky

V. Amnesty

VI. Collection

Address Collection Made in Field

VII. Information for the Review Auditor

A. Provide Any Information Pertinent for Review if it is a Basis for the Assessment. Do Not Include if Such Information is not the Basis for the Assessment.
B. If the Audit was Prepared on a Computer, Identify File by Name and Give a Brief Description of Adjustment Contained in the File.
C. Approval to Deviate from Established Test Period Policy (Attach Approval)
D. Provide information on vendor contacts (Attach vendor contact authorization)

VIII. Other Taxes

A. Verification of Returns Filed

1. Income Tax
2. Corporation License Tax
3. Intangible Property
4. Tangible Property
5. Severance/Mineral Tax
6. Withholding Tax
7. Partner/Shareholder Individual Returns Filed

IX. Conclusion

A. Results of Audit
B. Penalties

1. Provide Any Information That Would Be Helpful to The Department to Determine Application and/or Waiver of Penalties.

C. Position of Taxpayer. Give Explanation of Taxpayer's Position. Should also Include the Auditor's Counter-position.

X. Correspondence

A. State Name, Current Title and/or Position of Person With Whom Kentucky Department of Revenue Should Correspond.

PROCEDURES FOR NON-REGISTERED TAXPAYERS

Definition of Non-Registered Taxpayer: An individual or business that is doing business in this state that has not applied for a state tax identification number.

Practice: When an audit is performed on a non-registered taxpayer, the Field Division's auditor will give the taxpayer an application to complete. The auditor will obtain the completed application from the taxpayer and submit it to the Taxpayer Registration Section. In other instances the taxpayer will complete the application and mail it directly to the Taxpayer Registration Section.

The audit period for any non-filer is a minimum of eight years. The audit period will be extended if it is determined that such an audit of earlier years would be cost effective. It has been determined that an audit of earlier years will be cost effective if the Department assesses a tax amount of $ 1,500.00 or more per each period under review past the 8 year minimum.

Key Terms: "Application" means **Form 10A100-CS and Form 10A100 – Kentucky Tax Registration Application.**

VARIOUS QUESTIONS/ANSWERS

1. **Question:** Is it acceptable to give the taxpayer a disk reflecting the purchases subject to use tax or unallowable deductions? We recently had this request from an out-of-state taxpayer. The taxpayer requested this disk in order that they could more adequately review our findings by sorting the list of vendors.

Answer: Yes. Any audit schedule that has been prepared using Excel may be given to the taxpayer on disk. The audit templates contain no proprietary information.

2. **Question:** Can a taxpayer receive Department approval for homemade certificates?

Answer: Yes. The Department will allow taxpayers to use certificates other than those furnished by the Department provided the taxpayer obtains prior written approval from the Department. The taxpayer must submit a written request along with a copy of the proposed certificate.

3. **Question:** Does an entity under audit have the right to execute a vendor contact authorization after the taxpayer had previously rejected it but due to the results of the audit has a change of heart?

Answer: Yes. Every effort should be made to resolve all issues at the auditor level.

4. **Question:** Is there a set number of times that an audit must be rescheduled or the taxpayer's requests accommodated before an auditor can decide that he/she has complied with the "Taxpayer's Bill of Rights"?

Answer: Pursuant to **KRS 131.071,** the Department has the responsibility to perform audits at reasonable times and places and to advise the taxpayer of procedures, remedies and rights before any audit. There is no set number. After a reasonable amount of effort has been expended, notify the taxpayer via registered letter what actions will be taken if this deadline is not met. The options are an estimated assessment pursuant to **KRS 131.180(4)** being issued or the disallowance of all deductions. Inform the taxpayer what penalties (cite reference) will be assessed."

5. **Question:** Is there a number and type of attempts that an auditor should make to locate and contact a taxpayer before the audit is cancelled?

Answer: There is no set number. Be sure that all means of locating the taxpayer has been done. Utilize available databases. Whether an audit is cancelled or an estimated assessment is issued depends on the facts discovered, e.g., projected assessment, taxpayer's status.

6. **Question:** Can taxpayer records be moved to the TSC for audit?

Answer: Taxpayer records should not be removed from the audit site. They are not to be taken to the service center or any other location even if the taxpayer gives his/her approval. The problems associated with taking records from the audit site (taxpayer claims of altered records, lost records etc.) are simply too great. Should a situation arise where the taking of records from the audit site is needed, such action must be reviewed and approved in advance in writing by the chain of command of the Office of Field Operations (Audit supervisor, District Manager, Regional Manager and Executive Director). Under no circumstances are records to be removed from the audit site without prior written approval from the taxpayer and Field Operations management. To protect the auditor and the Department, a detailed inventory of what records are in the auditor's possession shall be prepared and signed by both parties. Give a copy to the taxpayer. When the books and records are returned to the taxpayer or his/her representative, the original receipt should be obtained with proper signature of the taxpayer or representative affixed thereto indicating their return.

7. **Question:** Can an auditor(s) accept materials from a taxpayer that are offered to the general public free of charge?

Answer: No. While you are auditing a taxpayer, do not accept anything from that taxpayer.

8. **Question:** Does the "Memo for the Record", which is prepared separately from the audit's narrative; violate the Taxpayer's Bill of Rights?

Answer: All audits are to contain the revised Agents' Narrative Report and not the letter of transmittal. Also, the revised audit selection transmittal sheet should be included. Memos for the record for those areas of the audit that cannot be discussed either in the Agents' Narrative Report or are not includable on the Audit Selection Transmittal Sheet are to be included in the audit folder. This change was made after much discussion and consultation with the Department's legal staff. The preparation of this "Memo for the Record" does not violate the Taxpayer's Bill of Rights.

9. **Question:** Can a contractor who is not classified as a contractor/retailer make exempt sales to exempt entities?

Answer: Once a contractor makes more than two sales at retail of the same scope and character, then the contractor is a retailer **(KRS 139.110)** and is classified as a contractor/retailer. Sales to exempt entities are sales at retail.

10. **Question:** Audits of Non-listed Taxpayers - Should the auditors register these taxpayers for all needed tax numbers? If the audit is cancelled but the taxpayer should be registered or should file, should the auditors register these taxpayers?

Answer: Yes to both questions. In all cases the auditor must advise the taxpayer what tax numbers are needed and provide the taxpayer an application. Collect the completed application from the taxpayer. If the application is not collected from the taxpayer, complete an 864 stating applicable facts and submit to the Compliance Section. Address the application in the narrative.

If the audit is cancelled and returns are due, advise the taxpayer to file the returns and provide assistance. A memo for the record should be submitted detailing what was done. If T/P fails to cooperate, use **Form 864** and submit to the Compliance Section.

11. **Question:** Can we require an out-of-state vendor who does not have nexus but who voluntarily registered with the Commonwealth for a sales tax permit be required to collect Kentucky use tax?

Answer: Yes. Once a taxpayer registers with the Commonwealth, that taxpayer is subject to the same requirements as a retailer engaged in business within this state. See **KRS 139.700 – Collection of tax by out-of-state retailer.**

12. **Question:** ABC Corporation is a 100% Kentucky corporation and operates a sod farm in Kentucky. The taxpayer both raises and severs the sod and always sells to the final consumer. The nature of this taxpayer's business is that the entity makes only two retail sales in any given year. Accordingly, is this taxpayer considered a retailer of sod or can the taxpayer invoke the provisions of **KRS 139.470(4) – Occasional Sale**?

Answer: **KRS 139.110 – Retailer** includes "Every seller who makes any "retail sale" or "sales at retail" . . . **KRS 139.100 – Retail Sale** indicates that "retail sale" or "sale at retail" means "A sale for any purpose other than resale in the regular course of business of tangible personal property . . . **KRS 139.140 – Seller** includes every person engaged in the business of selling tangible personal property . . . **KRS 139.040 – "Business"** includes any activity engaged in by any person or caused to be engaged in by him with the object of gain, benefit . . .

It is obvious that the taxpayer is engaged in a business. Secondly, it is equally obvious that the corporation is making retail sales of tangible personal property. In that **KRS 139.110** includes every seller who makes **any** "retail sale", it does not matter that only two (2) sales were made. The occasional sale provision is applicable for sales of tangible property not held or used by a seller in the course of an activity for which he is required to hold a seller's permit. It is fair to say that the sale of sod does not meet the definition of occasional sale.

13. **Question:** Are there any legal decisions as to the ownership of the rivers bordering Kentucky in regard to the taxable/nontaxable status of enterprises operating upon those rivers?

Answer: The United States Supreme Court has determined that Kentucky's boundary along the Ohio River with Ohio, Indiana and Illinois is the northerly low-water mark as it existed in 1792. (Ohio v. Kentucky and Illinois v. Kentucky) and its boundary with Missouri along the Mississippi River is the middle of the navigable channel (Missouri v. Kentucky). The Ohio River boundary, by agreement of the States and adopted by the Supreme Court, has been determined by using fixed geodesic points as to latitude and longitude and the boundary can be determined with precision by surveying. The Mississippi River would be the middle of the navigable channel as it exists from time to time.

14. **Question:** Discuss the Department of Revenue's position with regard to the expanding internet's activity in the areas of sales and purchases and the application of **KRS 139.200, KRS 139.310** and **Regulation 103 KAR 30:190?**

Answer: Internet service providers located in this state must pay tax on the cost of all equipment necessary to provide internet service to their customers.

If an out-of-state retailer has a physical presence in this state, thus having established nexus in the state, sales over the internet for delivery and use in Kentucky are still taxable and such retailer is required to charge tax at the 6% rate. Such sales would be considered sales in interstate commerce and the retailer would be required to charge Kentucky tax. On the other hand, Kentucky can not require an out-of-state retailer to collect and remit tax simply because the retailer makes sales of tangible personal property into this state via the internet.

The end result is that if the out-of-state retailer is not obligated to collect the tax on transactions over the internet, the purchaser is still liable for the 6% Kentucky Consumer Use Tax. The purchaser is not relieved of this liability just because he made an order by accessing a retailer's web-site any more than he is relieved from tax by purchasing tangible personal property through an out-of-state mail order company.

15. **Question:** Car Facts is an on-line service at automobile dealerships where the VIN number of a vehicle can be entered and the history of such vehicle can be obtained. The dealership pays a fee to have access to this service and while a potential buyer can get a printout of such history, the dealership may or may not charge for the hard copy. Is either the fee paid by the dealership to the provider for the service or the price paid by the potential customer for a hard copy taxable?

Answer: In that the tax base under **Chapter 139** is the sale/storage/use of tangible personal property or certain services, neither the fee paid by the dealership nor the price paid by the potential customer for a hard copy is a taxable transaction. The fee paid by the dealership for the service does not involve the sale of tangible property and it is not a taxable service. The price paid by the potential buyer to the dealership for use of this service does not constitute the sale of tangible personal property as the essence of the transaction is the rendering of a service and such service is not taxable.

16. **Question:** What is the treatment of audit assignments involving ownership changes during the audit period? For example, a taxpayer is a Sub S Corporation for year one of the audit period and the same responsible parties change their business structure to an LLC. Is the answer the same if the new LLC decides to operate as a partnership instead of the former corporate structure?

Answer: If a taxpayer operates as a corporation and changes to an LLC (electing to file as a partnership or corporation), the different entities should have separate CRIS numbers. Therefore, a sales tax audit would require two separate audit assignments – one for each sales tax number listed for each entity. If a corporation changes to an LLC after an audit has been assigned, the auditor should request an audit on the account number listed for the LLC.

The same procedure should be followed for corporation income tax audits. An exception could be an LLC electing to file as a partnership.

17. **Question:** What is the definition of a selling asset and list examples?

Manufacturer. What is a selling asset and does it include office equipment (such as copier, fax machine, computer equipment, and office equipment)?

Contractor who has a retailer's number. Do they have any selling assets such as those listed above?

Service entity that holds a retailer's number. Do they have any selling assets such as those listed above?

Answer: The sales and use tax law or regulations do not define the term "selling asset". However, **Sales Tax Bulletin 51F007 - Sale, Purchase or Lease of a Business,** dated January 1988 provided the following explanation of a selling activity asset.

"Accordingly, any assets comprising tangible personal property utilized in the operation of a motel or hotel or selling activity involving the sale of all types of merchandise, taxable services or admissions are taxable when sold by the retailer." Concerning the specific examples referenced above:

Manufacturer. In the case of *Revday Industries v. Revenue*, the Kentucky Supreme Court determined that there were two distinct activities, a manufacturing activity and a selling activity. A sales tax permit was not required to manufacture but a permit was required to sell the manufactured product. Accordingly, the court determined that assets used in the manufacturing area could qualify as an occasional sale while assets used in the selling area were subject to tax. The sale of such assets could not qualify as an occasional sale under **KRS 139.070**. Therefore, the sale of items such as copiers, fax machines, computer equipment, and office equipment used in the selling area would be subject to tax. **NOTE:** This same equipment could be non-selling activity assets if located in the plant area and used in the manufacture of the product.

Contractor. A contractor who makes retail sales would be subject to tax on the sales of assets used in making these sales. Such assets could include copiers, fax machines, computer equipment, cash registers, and office equipment.

Service Entity. A service entity that holds a sales tax permit would be subject to tax on the sale of assets used in making retail sales. Such assets could include copiers, fax machines, computer equipment, cash registers, and office equipment. However, the sale of assets used in a selling activity would not make the sale of other assets of the service entity used in activities that do not require the holding of a sellers permit subject to tax. **Example:** A laundry mat holds a permit to sell bleach, detergent, etc., from vending machines. While the sale of the vending machines would be subject to tax, the sale of the washing machines and dryers could qualify as an occasion sale. The washing machines and dryers are and remain non-selling activity assets.

18. **Question:** How strict an interpretation should an auditor place on the reciprocity statutes in the area of tax paid especially in the case of an out-of-state contractor?

Explanation of Question: A recent audit on an out-of-state contractor revealed purchases from another out-of-state contractor for items that the second contractor had paid Kentucky tax to various vendors, but when the invoices were issued to the consuming contractor, no Kentucky tax was reflected on the invoices and the selling contractor did not hold a Kentucky Sales and Use Tax account number.

Answer: **KRS 139.510** allows credit for state sales tax paid in another state against the use tax due in Kentucky provided: (1) the other state has a sales and use tax reciprocal statute similar to Kentucky, (2) the tax was actually paid to the other state, and (3) the tax was legally due the other state. Unless these requirements are met, no credit would be allowed for tax paid to another state. It is the taxpayer's duty to show that these requirements have been met. In addition, any credit allowed under reciprocity would apply only to the person who purchases the property.

The sale of the property occurred between two contractors who do not hold retail permits. Did the sale of the property qualify as an occasional sale under **KRS 139.170**? Tax would not apply to the sales if the selling contractor had not made more than 2 retail sales in any twelve-month period **(KRS 139.110).** Also, the selling contractor would not be entitled to any refund or credit for taxes paid.

If the sales did not qualify as occasional sales, tax would apply to the selling price of the property shown on the invoices. However, if the selling contractor's records show that the invoice included tax, the Department would allow the selling contractor to void the initial invoices and reissue corrected invoices showing the selling price of the property and applicable tax. The selling contractor would file a return with the Department reflecting the selling price of the property less a tax paid purchase resold deduction.

19. **Question:** An out-of-state contractor performs work within the state of Kentucky and purchases material from vendors both within Kentucky and out-of-state (Indiana). Assume that a Kentucky registered vendor incorrectly charges this out-of-state contractor 5% Indiana sales tax on a "will call" sale within the state of Kentucky. This is the result of contractor being domiciled in Indiana and being charged where their business is located instead of where the sale is being consummated.

Since this Kentucky registered vendor had collected Indiana sales tax in error who is responsible, the contractor or vendor, for the collection/payment of Kentucky's 6% tax?

Answer: Sales tax paid in error cannot be used to offset use taxes due. If the auditor becomes aware that the taxpayer is paying tax to his vendor on items that are exempt, or **has been charged the incorrect state's sales tax by his vendor**, the auditor should advise the taxpayer to make a request to his vendor for a refund.

All applicable taxes properly due Kentucky must be assessed and held as a liability to the Commonwealth. The end result in this situation is that the 6% tax due would be assessed against vendor. **KRS 139.200 – Imposition of Sales Tax**

20. **Question:** When can the "Reporting Agreement" be used and when can't it be used? Is it specifically for the carpet retailer/contractor?

Answer: The use of the "Reporting Agreement" applies only to taxpayers who should be reporting their sales and use tax on a contract basis pursuant to the rationale of the Bryant-Burnett decision and/or **Regulation 103 KAR 26:070** (Construction Contractors). Therefore, the "Reporting Agreement" may be used in any situation where a business has reported as a retailer but should have reported as a consumer under **103 KAR 26:070.**

TAXPAYERS' BILL OF RIGHTS

House Bill 802 amended and created various new sections of **KRS Chapter 131** to establish a Kentucky Taxpayers' Bill of Rights.

Although some of the rights already existed either by policy or law, many represent new rights or expanded benefits to Kentucky's taxpayers. The "rights" have been codified under **KRS 131.041** through **KRS 131.081**.

The Department is required to advise taxpayers of their rights under the taxing statutes of the Commonwealth of Kentucky. To furnish this information to taxpayers, the Department has prepared a brochure concerning the Taxpayer Bill of Rights. The brochure, "Your Rights as a Kentucky Taxpayer", must be furnished at the time of the initial contact with a taxpayer, whether by mail or a visit to his office for audit purposes.

Right to Make Audio Recordings Under Taxpayers' Bill of Rights

KRS 131.081(5) reads as follows: (Section 4(5) of HB 802)

> Taxpayers shall have the right to make audio recordings of any conference with or hearing by the Department. The Department may make similar audio recordings only if prior written notice is given to the taxpayer. The taxpayer shall be entitled to a copy of such Department recording or a transcript thereof as provided in **KRS 61.874**.

This provision sides with or favors the taxpayer with regard to such rights. The terms "conference" or "hearing" implies that a meeting has been scheduled. It does not necessarily cover a "walk-in" situation. However, to be on the safe side, the Department should assume that the taxpayer has the right to record any meeting regardless of how formal or informal, scheduled or unscheduled. How does a Department employee respond to a situation when a taxpayer is prepared to audio record a conference and the Department employee is or was unaware of the taxpayer's intention to do so?

The following should be helpful in answering this question whether Department personnel are conducting a field conference, an office conference or any other type of conference.

<u>For an unscheduled conference that the taxpayer wants to record</u> – Unless you believe the taxpayer's integrity and character is such that you would not be placed in any kind of jeopardy that could result from an altered tape, you should not concern yourself with recording the meeting. If there is a concern, you should advise the taxpayer that you also wish to record the conference but that you are required to give him "prior written notice." If you have accessibility to an audio recorder and the taxpayer is willing to waive his specific right to a "prior written notice" under Section 4(5) of the bill, (see sample of waiver) you can proceed to record the meeting also. If you do not have access to a recorder or the taxpayer refuses to waive the "prior written notice" requirement, you should advise the taxpayer that he must give you ample time to acquire a recorder or to give him "prior written notice" before conducting the meeting.

<u>For a scheduled conference that the taxpayer wants to record but does not advise you in advance</u> – Unless you feel comfortable that the taxpayer would not alter the tape in any way, you can advise the taxpayer that (for your own protection) you will also record the conference once you acquire a recorder and the taxpayer waives his right to the "prior written notice" under Section 4(5) of the bill. If the taxpayer is unwilling to waive the notice requirement and you are not comfortable with the idea that the taxpayer has the only recording of the meeting, you should advise the taxpayer that the meeting will be rescheduled until such time that the taxpayer is given "prior written notice."

The following language is a suggestion of how you could word correspondence concerning the taxpayer's right to record when corresponding with a taxpayer regarding a conference or meeting:

> The "Kentucky Taxpayers' Bill of Rights" grants taxpayers the right to make an audio recording of any conference with or hearing by the Department. Should you choose to make such a recording at the time of the conference or hearing? In order to prevent any delay of the conference, it is recommended that you contact the Department in advance of the conference (or hearing) if you intend to record the conference so that the Department can be prepared to record the conference if it so chooses. The bill also provides that taxpayers shall have the right to be assisted or represented by an attorney, accountant or other person in any conference, hearing or other matter before the Department.

Alternative Language

If you elect to make an audio recording of the conference with the Department, this is to give you prior written notice as required by the Kentucky Taxpayers' Bill of Rights that the Department will make its own audio recording of the conference. You are urged to contact the Department in advance of the conference if you intend to record the conference in order that the Department can be prepared to record the conference. The conference may be delayed if the Department is not given reasonable prior notice of your intentions to record the conference. The Bill of Rights also provides that taxpayers shall have the right to be assisted or represented by an attorney, accountant or other person in any conference hearing or other matter before the Department.

What is meant by the term "prior written notice?" As a matter of policy, any intention of Department personnel to record a conference should be preceded by a written notice delivered at least 24 hours in advance unless the taxpayer is willing to waive his right to such notice. I do not think it would be proper to hand the taxpayer such notice immediately preceding a conference – simply because the taxpayer may not be prepared to record the conference without due notice.

The following is a suggestion on how a waiver of the taxpayer's right to prior written notice might be worded:

> I, _____, hereby waive the requirement of the Department or Revenue to provide me with a prior written notice to make an audio recording of a conference scheduled on _____ pursuant to **KRS 131.081(5).**

_____
Signature

_____
Date

KRS 61.874 as referred to in **KRS 131.081(5**) is a part of the open records law.

The content of this memorandum is not to suggest or insinuate that taxpayers who audio record a conference have intentions of altering or "doctoring" a tape. However, the fact is that a tape once copied and altered could certainly pose problems for the Department employee and the Department. Good judgment must come into play in order to protect the employee and the Department.

As stated earlier, this particular right was designed primarily to benefit the taxpayer; however, it gives the Department the same right but with a little added burden. The subsection of the bill grants this right needs amending to permit the Department to simultaneously record a conference without giving prior written notice if the taxpayer is prepared to record the conference.

PENALTIES

KRS 139.980 – Civil Penalties

KRS 131.180 – Uniform Civil Penalty Act

KRS 131.175 – Secretary Authorized to Waive Penalty, but not Interest

Department of Revenue recognizes that the a vast majority of taxpayers voluntarily comply with the tax laws of the Commonwealth and support government by paying their fair share of taxes in a timely manner. However, there are times when a taxpayer, for whatever reason, is unable to comply with the tax laws and, as a result, will incur penalties.

If a taxpayer can demonstrate reasonable cause for failure to comply with a Kentucky tax law, the Department has the authority under **KRS 131.175** to reduce or waive penalties. Reasonable cause justifications may be submitted to the Department with the filing of a tax return, payment of tax or after an assessment has been issued by the Department.

Reasonable cause is defined in **KRS 131.010(9)** as an event, happening, or circumstance entirely beyond the knowledge or control of a taxpayer who has exercised due care and prudence in the filing of a return or report or the payment of moneys due the department pursuant to law or administrative regulation.

A taxpayer's demonstration of reasonable cause will be reviewed by the Department to determine if the penalty should be waived or reduced. The reduction or waiver of a penalty for reasonable cause acts as a safety valve to prevent injustice to a taxpayer when an event, happening or circumstance has occurred that is entirely beyond the knowledge or control of a taxpayer and has prevented the timely filing or payment of a tax.

Uniform Civil Penalty Act.

KRS 139.980 imposes the uniform civil penalties pursuant to **KRS 131.180** on any person who violates the provisions of this chapter. Guidelines for the application of the Uniform Civil Penalty Act (UCPA) were developed to provide uniformity in the application of civil penalties regardless of the type tax involved. These guidelines support the Department of Revenue's mission to administer the tax laws of the Commonwealth in a fair and impartial manner.

The purpose of these guidelines is to provide a clear understanding of the nine separate penalty provisions as outlined in **KRS 131.180**, the application of each penalty, and the basis for reduction or waiver when reasonable cause is demonstrated.
These separate policy provisions are:

- Late Filing
- Late Payment
- Underpayment or Late Payment of Estimate Income Tax
- Failure to File or Failure to Furnish Information
- Failure to Timely Pay Non Protested Tax Assessed by the Department
- Failure to Timely Obtain any Required Tax Identification, Number, Permit, License, or Other Document of Authority
- Negligence
- Fraud
- Unhonored Check

Subsections 10 through 13 of **KRS 131.180** provide information and support for the administration and collection of the nine penalties know as the Uniform Civil Penalty Act.

Pursuant to **KRS 131.180(12),** application of these penalties is not mutually exclusive; they may run concurrently or "stack", which means more than one penalty may apply. For example, if a return is filed late and the taxes are paid late, then both the **Late Filing** and **Late Payment** penalties may apply.

All penalties provided in the UCPA may be reduced or waived by the Department if reasonable cause is demonstrated. If the request for reduction or waiver is denied, the request may be appealed in accordance with the protest and appeals guidelines for timely or untimely protest.

KRS 139.990 – Criminal Penalties

Criminal penalties include Class B misdemeanor and Class D felony as addressed in the statute.

KENTUCKY TAX AMNESTY - 2002

General Information

The Tax Amnesty Program was an opportunity for taxpayers to pay taxes owed for certain back periods without interest, penalties or fees and without prosecution. House Bill 614, enacted during the 2002 Kentucky General Assembly, required the Department of Revenue to conduct the Tax Amnesty Program.

The 2002 Tax Amnesty Program brought in over 100 million of much needed revenue to the state during the 61 day period. But once the Tax Amnesty Program was over, the Department was required to impose new penalties and take steps to aid in collecting liabilities not paid under the amnesty program.

House Bill 614 enacted by 2002 General Assembly requires the Department of Revenue to:

- Effective October 1, 2002, increase cost of collection fee from 20% to 25% for assessment periods eligible for Tax Amnesty and for all other due and payable accounts receivable, regardless of when due. Any additional tax assessed by the Department after September 30, 2002, for any reporting period ending prior to December 1, 2001, will be assessed a 25% assessment cost of collection fee (AA fee code, 8 or U fee base). This fee is only applicable to audit assessments issued by the Department. This fee is not applicable to taxes that are self-assessed by the taxpayer.

  On field audits, the Division of Audit Review and Protest Resolution will be responsible for billing this fee. On the 18-month review program, this fee will not be assessed.

- Effective October 1, 2002, assess a 50% cost of collection fee for nonfiled returns.

  Any tax assessed by the Department after September 30, 2002, for any reporting period ending after December 1, 1987, and before December 1, 2001, for failure to file a required return will be assessed a 50% failure to file cost of collection fee (BB fee code, 2 or U fee base). These assessments for failure to file are the ones made pursuant to **KRS 131.150** and **KRS 131.180(4).** If the return is subsequently filed, the percentage will remain the same. However, the base will be changed to reflect the tax due shown on the return.

  Field personnel should be adding this fee to assessments for failure to file. This fee is in addition to the penalties currently added to the bill.

- Extend corporate officers' personal liability to include motor fuels taxes, in certain circumstances.

- Impose personal liability of limited liability partners and members for withholding tax, motor fuels taxes and sales tax for all tax periods.

- **Interest on Property Tax Bills.** Interest on Property Tax bills will continue to accrue interest until date paid, including outstanding liability in the system on January 1, 2003.

- **Post Listing of Delinquent Taxpayers.** Secretary given the authority to post listing of delinquent taxpayers on the Internet. Bills must be due and payable and have tax liens or judgment liens filed.

Additional Penalties

Effective January 1, 2003

Minimum Estimated Assessment Penalty. For any estimated assessment issued pursuant to **KRS 131.180(4)** for reporting periods ending on or after January 1, 2003, the Department will assess the failure to file penalty (penalty code DA, penalty base 3 or U). However, the minimum penalty assessed will be $100.00. The penalty will not be decreased below $100.00 by any subsequently filed return, even if the return filed results in a refund.

Field personnel will assess this penalty on estimated assessments on the purchase of business assets (bill reason SOP). Once assessed the penalty code will not change and the penalty will not be reduced below $100.00 should the taxpayer then provide the needed information to determine the correct tax due.

The penalty will not be assessed on assessments for business assets where the taxpayer has furnished information for determining the correct tax liability prior to an estimated assessment being issued (bill reason XOP).

Minimum Jeopardy Assessment Penalty. For any jeopardy assessment issued pursuant to **KRS 131.150** for reporting periods ending on or after January 1, 2003, the Department will assess the late file penalty (penalty code AJ, penalty base 3 or U). However, the minimum penalty assessed will be $100.00. The penalty will not be decreased below $100.00 by any subsequently filed return, even if the return filed results in a refund.

Field personnel issue jeopardy assessments on back returns (bill reason WR) and through OSCAR on the annual filer delinquency program. Back returns are those returns that are due for periods before the taxpayer registered and do not show as a delinquency on any of the tax systems.

This penalty will not be assessed at the time the jeopardy assessment is issued. The penalty will be applied to the bill at the time the return is filed even if that return shows no tax due or a refund.