

Kentucky tax penalty waivers

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Everyone hates tax penalties. Even the law does not like them. “[T]he law never favors penalties and will not exact them unless the statute is clear and convincing.” *Commonwealth ex rel. Martin v. Tom Moore Distillery Co.*, 152 S.W.2d 962, 964 (Ky. 1939). Nonetheless, because the law provides for penalties and the Kentucky Department of Revenue assesses penalties, taxpayers, and consequently tax practitioners, must deal with penalties on an ongoing basis.

Penalties, penalties everywhere

The Revenue and Taxation Chapters of the Kentucky Revised Statutes provide for the imposition of penalties. Regardless of tax type, the potential exists for the sting of penalties to be felt, at least initially, absent the Department’s exercise of its discretion to waive penalties on the front end when reasonable cause is present.

Many tax types provide for penalties in accordance with the Uniform Civil Penalty Act of KRS 131.180. Income taxes do [KRS 141.990]. Sales and use taxes do [KRS 139.980]. There are, however, exceptions, like property taxes that have their own penalty scheme.

The Uniform Civil Penalty Act provides for different types of penalties. The most common is the failure to pay penalty of 2 percent of the total tax due for each 30 days not paid with a 20 percent maximum. It is imposed when a taxpayer either fails to pay the tax due on a return or at least 75 percent of the

tax the Department has determined to be due, *i.e.*, on audit. Another common penalty is the failure to file penalty, which similarly is 2 percent of the total tax due for each 30 days not filed with a 20 percent maximum. Ordinarily, these penalties are imposed at the 20 percent maximum rate, particularly on audit because more than 10 months have passed.

Other types of penalties are quite uncommon. For example, the 10 percent negligence penalty or the 50 percent fraud penalty. These penalties are encountered much less frequently because the vast majority of Kentucky taxpayers are not negligent and are not committing fraud when they file (or decide not to file) their tax returns.

Other penalties appear to be intended to facilitate Department audits of tax returns. For example, “if any taxpayer fails or refuses to make and file a report or return or furnish any information requested in writing by the Department, the Department 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, and

add a penalty equal to five percent (5 percent) of the tax assessed for each thirty (30) days or fraction thereof that the return or report is not filed.” KRS 131.180(4). The maximum penalty is 50 percent. A double-assessment with a 50 percent penalty will get someone’s attention, though most times, a call, letter or reminder is sufficient to gain the information requested, without actually having to swing the penalty hammer.

Other penalties are geared to collections. One example is the penalty for failure to pay assessed tax that is final, due and owing of 2 percent of the total tax due for each 30 days (no maximum). Another example is the 10 percent penalty for an unpaid presented check which is assessed at between \$10 and \$100; this provision operates like a returned check fee, similar to what a bank might charge.

Post-Amnesty penalties.

There are more penalties now that the Tax Amnesty Program the Department ran between Oct. 1, 2012 and Nov. 30, 2012 is over. The time for paying all amnesty amounts ended on May 31, 2013.

Amnesty penalties are beginning to appear on assessments. There is a cost-of-collection fee of 25 percent of taxes assessed and collected after the amnesty period for taxable periods ending or transactions occurring prior to October 1, 2011, and there is a 50 percent cost-of-collection fee for any taxpayer who failed to file a return for any previous tax period for which amnesty was available. These are the amnesty

equivalent to the failure to pay and file penalties, respectively.

An additional cost-of-collection fee of 25 percent applies to all taxes which are or have become due and owing for any reporting period, regardless of when due. This is the amnesty equivalent to the penalty for failure to pay a final, due and owing tax.

Reasons for penalty waiver

The Department has the authority to waive penalties for reasonable cause, whether imposed by the Uniform Civil Penalty Act or under Tax Amnesty. See KRS 131.175; KRS 131.440(2). Many circumstances for which a waiver of penalties may be appropriate can be found in the Department's

Penalty Regulation, 103 KAR 1:040. A taxpayer's non-compliance resulting from circumstances beyond their control is reasonable cause and warrants a waiver. Examples include: death or serious illness of a taxpayer or someone in their immediate family; death or serious illness of a taxpayer's tax return preparer; a taxpayer's unavoidable absence; destruction or unavailability of taxpayer records due to a catastrophic event (e.g., fire, flood, storm damage, etc.); the inability to obtain records in the custody of a third party; employee theft or defalcation; or, undue financial hardship.

Reasonable cause for alleged non-compliance may also exist because the

taxpayer or their tax advisor obtained and relied on written advice from the Department. This circumstance is noted in the Kentucky Taxpayer Bill of Rights. See KRS 131.081(6).

Substantial authority and disclosure provide reasonable cause. The regulation requires a taxpayer's reliance on substantial authority at the time of the non-filing or non-payment and conspicuous, full disclosure on the return, including the relevant legal authority relied upon.

Similarly, reliance on a tax adviser's advice is another circumstance demonstrating reasonable cause. An example of this circumstance can

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be found in *Genex/London, Inc. v. Department of Revenue*, 622 S.W.2d 499 (Ky. 1981). Under the Regulation, multiple factors are considered: the taxpayer's unfamiliarity with the tax laws and actual reliance on the tax advice; supporting documentation, including a copy of the advice requested and provided, including an explanation of the circumstances; and, the taxpayer's exercise of reasonable care and prudence in determining whether to secure further advice. In sum, this means that the Department can be expected to request a copy of the advice. Think about it. The potential implications of this are beyond the scope of this article.

Mistakes happen. Human error, particularly when self-corrected, is another circumstance where reasonable cause is present. Likewise, ignorance of reporting requirements could be reasonable cause, particularly when a taxpayer has limited education or lacks tax and penalty experience. So, ignorance of the tax law can be an excuse.

What if a taxpayer's circumstance does not fall precisely within these circumstances? A taxpayer may still establish reasonable cause for the alleged non-compliance under facts warranting a penalty waiver.

Criminal penalties

Although the clear focus here is on civil penalties, the potential for criminal penalties should not be ignored. Criminal penalties can apply for willful bad conduct. For example, a taxpayer who willfully fails to file a return or makes a false return with the intent to evade payment of the tax or amount collected (or some portion thereof) runs the risk of being prosecuted for a felony. The Department's Division of Special Investigations has pursued and obtained indictments, guilty pleas and convictions for criminal non-filing. If you have a client who has been contacted by the Division, advise your client to contact an attorney.

"I may have found a way out of here." - Frank Marvel in Escape from Alcatraz (1979)

Tax penalties can add up. On a typical post-amnesty Notice of Tax Due, one can expect to see a 20 percent failure to pay penalty as well as a 25 percent cost-of-collection fee, provided that reasonable cause was not immediately apparent to the Department. In a failure to file situation, the penalties could be much higher. Do the math.

As penalties increase in magnitude, tax practitioners must be zealous advocates for their clients to prevent the assessment of penalties and to advocate for a waiver of penalties assessed. Being aware of potential penalties and circumstances demonstrating reasonable cause is the first step.

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KyCPA working to resolve LLET issues

KyCPA has heard from numerous members that the Kentucky Department of Revenue is disallowing various deductions in the cost of goods sold (COGS) calculation, resulting in large limited liability entity tax (LLET) assessments.

If your client receives an assessment from the Department you believe is not accurate, be sure to submit a written protest within 45 days of the notice date stating the reason for the protest. It is best to resolve these issues through the protest resolution process. For 2012 Kentucky returns, you should also include a supplementary schedule so that the Department can understand the types of costs that are being deducted.

The Department is reviewing protests related to this issue on a case-by-case basis, and is expected to release guidance in its August *Tax Alert*, which can be accessed on the Department's Web site at revenue.ky.gov under the Newsroom - Publications tabs.

KyCPA members and staff have discussed this issue with the Department on multiple occasions and will continue to do so. We hope to find a joint resolution that will simplify the process for both CPAs and the Department moving forward.