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Informal and Invisible Guidance in Kentucky Creates Transparency

Issues

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News Analysis

The Kentucky Department of Revenue's refusal to release documents such as final rulings and other written guidance, combined with its informal approach to issuing written guidance, has created significant transparency problems within the state, practitioners say.

Kentucky, like many other states, issues written guidance to taxpayers who request answers about the application of statutes or regulations to their situations. Most states issue formal, written guidance -- commonly called letter rulings -- and publish redacted versions of the guidance for all taxpayers. A few states keep their letter rulings secret, usually citing taxpayer privacy or a lack of legislative authority to publish them.

Kentucky appears to be unique in that it offers written guidance fairly informally and with limited statutory authority. The guidance isn't binding on the substantive question, but taxpayers take it seriously.

While shielding that guidance from public scrutiny by keeping it confidential, the DOR has also apparently failed to devise any formal internal controls to track the informal guidance it offers and ensure its consistency with statutory law or previously issued guidance.

Practitioners don't believe the DOR is intentionally trying to prevent taxpayers from understanding the tax law, as has been alleged in other states, specifically North Carolina. (For coverage of transparency matters in North Carolina, see *State Tax Notes*, July 16, 2012, p. 149, *Doc 2012-14299* [📄](#), or *2012 STT 136-1* [📄](#).)

The DOR appears to be trying to treat taxpayers fairly in relation to other taxpayers, but its refusal to issue other documents, such as final rulings, combined with its casual approach to offering written guidance is problematic.

Hazy Statutory Authority for Written Guidance

Kentucky law allows certain administrative agencies to issue binding rulings in response to citizen requests for an interpretation of "the applicability to any person, property, or state of facts of a statute, administrative regulation, decision, order, or other written statement of law or policy." A 2007 court of appeals decision, *Baker v. Kentucky Retirement Systems et al.*, explained that agencies that lack explicit authority are barred from issuing guidance.

That authority has not been explicitly extended to the DOR, although the department has been charged with providing advice on "all questions respecting the construction of state revenue laws and the application thereof to various classes of taxpayers and property." Although that guidance would be known as letter rulings in most other states, it is referred to as a declaratory ruling or an advisory opinion in Kentucky. "Letter ruling" refers to the DOR

letter rulings, which aren't binding but are otherwise similar to other agencies' rulings.

When asked about the authority for the DOR's written guidance, a Finance and Administration Cabinet spokeswoman said that despite the lack of a formal process for providing letter rulings, the department's policy is to respond to "all taxpayer inquiries requesting our position on technical tax matters."

The department has the authority to offer some sort of written advice, as KRS section 131.081 references "written advice from the department." And KRS section 131.130(4) directs the DOR to respond to taxpayer questions, but it also appears to limit its authority to explaining the application of the law "to various classes of taxpayers and property."

It is unclear what that limitation entails. One Kentucky practitioner told Tax Analysts that a client received a ruling stating that section 131.130(4) does not require the DOR to issue rulings for individual taxpayers, though it provides a substantive response anyway, as the facts and legal issue may not be limited only to the individual taxpayer requesting the letter, according to the ruling.

Because those letters are not widely published or even available to other taxpayers, it is likely that the advice is not intended for a class of taxpayers, but for the individual taxpayers only. Other letters obtained by Tax Analysts lack the "classes of taxpayers" disclaimer and are apparently meant to be specific only to the taxpayer.

Written Guidance -- Binding

Despite a lack of clarity regarding the DOR's authority to issue guidance to individual taxpayers, the department's written guidance does not appear to cross the line into being an unauthorized advisory opinion, because it isn't binding on the agency on the substantive issue.

As the court noted in *Baker*, advisory opinions are by definition binding on the government agency that issues them. But DOR rulings are binding only to the extent they affect penalties and possibly interest.

KRS section 131.081 states that if a taxpayer fails to file a return or make a payment "due to the taxpayer's reasonable reliance on written advice from the department, the taxpayer shall be relieved of any penalty or interest with respect thereto," so long as the taxpayer adequately describes its facts and circumstances and the DOR hasn't modified or rescinded its advice in writing.

Thus, if a taxpayer relied on written advice from the DOR, the advice would be nonbinding in the sense that the department could change its position and require a different tax result. However, it is binding in the sense that the department generally won't make taxpayers worse off for having followed its initial position.

Erica L. Horn, counsel to Stoll Keenon Ogden PLLC, Lexington, said that in her experience, as long as the taxpayer's initial letter request was accurate, the DOR was "reasonable about penalties" even if officials were "not afraid to change their minds."

However, interest was typically assessed in this situation unless the taxpayer had "an ironclad letter," Horn said.

The letters are not binding, but that doesn't mean they aren't consequential. If a dispute develops and the department indicates that it will change its opinion on an issue, the letter ruling will be the taxpayer's first line of defense.

Timothy J. Eifler, also of Stoll Keenon Ogden, said the DOR has a strong track record of standing by its rulings despite their nonbinding status.

An Informal Approach

The department declined to describe its protocol for issuing or tracking its written guidance. But practitioners describe an informal process that emphasizes personal relationships and institutional knowledge.

Mark F. Sommer, chair of the tax and finance practice group at Bingham Greenebaum Doll LLP, described a "free-form" and "ad hoc" process by which taxpayer representatives approach DOR staff who they know in order to receive written or verbal guidance about a tax matter. Those officials then either handle the request themselves or send it elsewhere in the department.

"I don't think there is a formal process," Eifler said, adding that instead, "certain folks for each tax" handle the requests and senior officials eventually sign off.

Other times, Sommer said, the process starts with a preliminary discussion with a senior official, who may advise the taxpayer how to proceed.

That process may seem refreshingly unbureaucratic, but it can have drawbacks. Describing the practice for receiving written guidance as "very informal," Horn added that the DOR can be a "closed shop unless you know all the players."

Also, the DOR's failure to publish its written guidance greatly benefits large tax practices, which can accumulate and rely on legal guidance that is unavailable to smaller firms or individual taxpayers. Horn described one colleague's accumulation of guidance as "a treasure trove" and noted that someone who practices tax only occasionally may not even know what to do, given the DOR's unadvertised and informal approach to providing written guidance.

Those with significant experience would be expected to have an advantage over the less experienced when navigating the legal system or the tax code. But it undermines fairness when that advantage is gained through access to secret guidance or through personal relationships not available to all taxpayers.

Despite their dissatisfaction with the lack of information, Kentucky practitioners do not suggest the DOR is intentionally misleading taxpayers, treating similarly situated taxpayers differently, or otherwise attempting to improperly enforce the tax code.

"For the most part, the department tries hard to treat everyone the same," Horn said.

Still, there is frustration among practitioners, who assume the DOR is issuing written guidance that is relevant to their clients but unavailable to them.

Final Rulings

The DOR also issues written final rulings, its final decision on a disputed assessment before moving to the Kentucky Board of Tax Appeals.

Although the rulings are final determinations by an administrative agency, they are not published or otherwise available to the public unless and until the taxpayer elevates the appeal to the tax appeals board, an independent agency that operates under the state's Public Protection Cabinet.

Sommer recently tried to obtain final rulings via an open records request but was rebuffed on the grounds that the rulings are private until the taxpayer files an appeal with the board. The department's response to the request stated that it would be nearly impossible to adequately redact the records and that the request was therefore "unduly burdensome" under KRS section 61.872.

Jennifer Y. Barber, an associate at Bingham Greenebaum Doll LLP, questioned the state's practice of keeping secrets when agencies in other states are able to achieve much higher levels of disclosure. She noted the increased availability of records at the federal level and in neighboring Indiana, where revenue officials regularly redact the equivalent of Kentucky's final rulings and publish them online in batches.

"It seems fairly logical that a taxpayer's need for transparency in Kentucky is no different from the need of taxpayers in other states, so why is transparency different?" Barber asked. "If Indiana can publish its letters of findings, why can't Kentucky? And with over a thousand private letter rulings issued per year, even the IRS publishes its PLRs in a redacted and electronic manner."

An Open Records Dispute

More questions about the department's approach to transparency are raised by its position in an ongoing dispute over access to a list of taxpayers registered to pay the state's utility license tax.

Despite having its claim rejected by both the attorney general and the circuit court, the DOR continues to press its case for keeping the information secret. Eifler sought the information on behalf of a client that purchases gas from suppliers and resells it to commercial and industrial customers.

The taxpayer wasn't subject to the 3 percent utility tax -- known as the "school tax" -- until the DOR, rather than local school districts, began administering the tax in 2005. The taxpayer questioned what legal change had occurred that would affect its tax status and was informed by the DOR that similarly situated businesses were paying the tax.

Eifler sought to verify the claim by seeking the registration information via an open records request in which he acknowledged the DOR's authority to redact private information such as gross receipts and Social Security numbers. The information was important, according to Eifler, because in a small-margin business like a gas distributor, the nonpayment or payment of tax can be the difference in whether a company turns a profit. If only some gas distributors are paying the tax, "holdouts can monopolize the market," Eifler said.

In July 2010 the DOR's open records coordinator denied Eifler's request on the grounds that it would constitute an "improper disclosure of the taxpayers' business affairs." The denial stated that creating a query for the information at issue in the department's database would require divulging a taxpayer's filing status related to its energy consumption.

Attorney General Jack Conway (D) rejected the DOR's position and concluded that the department improperly invoked portions of the state's open records act to deny the information request. Conway declined to focus on the database issues and instead based his decision on the request to receive redacted copies of utility tax registration applications.

Conway's opinion said that taxpayers have a right to expect that the DOR will protect their confidential information. However, it said, that right must be balanced against the "public right to know whether the burden of public expenses is equitably distributed, and whether public employees are diligently collecting delinquent accounts." (For the opinion, see *Doc 2012-15134* )

Conway also cited a 2010 court of appeals decision finding a public policy interest in allowing the public to have access to redacted applications for occupational licenses. (For the decision, see *Doc 2012-15137* )

The attorney general wrote that "information that reveals the affairs of any person or any person's business is excluded from public inspection." That information, he said, does not include a taxpayer's name, address, and business or profession. Thus, Conway concluded the DOR was using an overbroad interpretation of the open records act to improperly deny Eifler access to the records.

The DOR appealed to the circuit court, which issued an opinion granting Eifler's request in January 2012. The department has apparently appealed that decision to the court of appeals, where an online docket indicates that the case is entering the briefing stage.

The DOR's continued appeal of the decision is typical, according to Eifler, who said the department generally "appeals everything." He said the DOR's focus on taxpayer privacy is also consistent with its traditional concerns regarding confidentiality, but he said he believes a court order should be sufficient to overcome the privacy concerns in situations like this one.

Conclusion

Many tax practitioners in Kentucky seem to agree with Eifler's assertion that compared with other states, there is a lack of transparency in Kentucky. That is especially true regarding the publication of written guidance such as letter

rulings and final rulings.

At the root of the transparency problems may be the informality of the DOR's written guidance procedures. The department does not appear to be exceeding its statutory authority, which provides a legal basis for offering the nonbinding written guidance it provides.

However, the scant legal authority and the lack of a formalized structure appear to contribute to the transparency problem by overemphasizing personal relationships and institutional knowledge rather than allowing for the reliable, consistent, and open guidance that is available in states with a more formalized ruling process. Creating further uncertainty is the written guidance that although critical to taxpayers, is not binding on the department. The department's emphasis on taxpayer privacy also seems excessive, as evidenced by its refusal to publish final rulings and its continuing litigation over registration records.

There may be an opportunity for improvement, as the state is considering an overhaul of its tax system. The Governor's Blue Ribbon Commission on Tax Reform, chaired by Lt. Gov. Jerry Abramson (D), is scheduled to release its findings and recommendations on November 15. Two of the commission's goals are promoting a tax system that meets standards for fairness, as well as simplicity and compliance. Addressing the DOR's use and publication of written guidance would be important steps toward those goals.

The DOR and the state's taxpayers would be better served by a more formalized procedure for issuing and disclosing guidance, which would remove ambiguities and level the playing field so that all taxpayers would have access to the DOR's rulings and other written guidance.

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