Kentucky Tax Challenges Facing Small Businesses

Taxes are a challenge for small businesses. One that they ignore at their peril. One that they must address.

What Is a Small Business?

What constitutes a small business is in the eye of the beholder. Some definitions make the determination by reference to the amount of sales, others by reference to the number of employees, still others by amount of assets of the business, and some use a combination of reference points. Regardless, these measures are all relative, and each business that considers itself to be a small business is likely just that.

The Burden of Compliance

Kentucky tax laws generally impose the same filing requirements on small business as they do on medium and large businesses. All businesses are required to: identify what taxes apply to them; collect, gather, and assemble tax return information; determine estimated payments; and, prepare and timely file tax returns along with making timely payments. In particular, small businesses have to comply with comparatively fewer resources than larger businesses.

The question then becomes how can small businesses reduce their compliance burden? On the sales tax front, small businesses may request quarterly or annual filing, rather than monthly filing, under KRS 139.590. Other than that, however, the filing requirements for all businesses are virtually identical for personal property tax and for income tax, with more complex rules taking a disproportionate toll on small businesses. Nonetheless, this makes it more imperative for small businesses to try to get it right on the front end to manage the risk of a tax assessment on the back end. As a general premise, the old saying that an ounce of tax compliance prevention can be worth a pound of tax assessment cure.

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Tangible Personal Property Taxes

For small businesses with few assets, the hassle and cost of preparing and filing a tangible personal property tax return may often exceed the actual tax assessment. This is particularly true for the smallest businesses.

Income Taxes

Most small businesses operate as pass-through entities, oftentimes, as limited liability companies taxed as partnerships or as LLCs or corporations taxed as S corporations. So, the income tax compliance burden often falls on the owners, although small businesses have to file annual income tax returns and provide their owners with K-1s to report and pay tax on their pass-through income. Ironically, the Kentucky income tax rules for pass-through entities can be complex.

For example, small businesses are subject to the related party expense disallowance calculation, regardless of the dollar amount. Also, the Limited Liability Entity Tax drastically increases the complexity of small businesses' Kentucky tax returns, not just with regard to calculating the LLET but also in flowing through the LLET credits. As such, when the Department assesses LLET against a small business, that small business often must address one if not two issues – calculation of the LLET *and* creditability of the LLET, if ultimately paid.

Sales Taxes

Sales tax is perhaps the tax that is most likely to trip up small businesses in a significant way, particularly if there is a mismatch between the way the small business and the Department think that the Kentucky sales tax rules apply.

There are a myriad of sales tax exemptions. Some apply based on the status of the purchaser, *e.g.*, a resident tax-exempt non-profit entity, an out-of-state tax-exempt entity. Some apply based on the type of transaction, *e.g.*, for a purchase for resale, occasional sale, etc. Others apply based on the type of property, *e.g.*, food, which is an extremely complex exemption.

Given this complexity, there are many ways a small business can get crossways with the Department. For example, they may not obtain or keep documentation of exempt sales, such as exemption certificates or resale certificates, and the exempt organization or reseller may no longer be a customer when the Department audits. Or, there could be a disagreement as to the application of an exemption to a particular product (or products) that a small business sells. Six percent of gross sales can add up very quickly!

Disputing Tax Assessments

When the Kentucky Department of Revenue issues a Notice of Tax Due to a business to assess a tax, the process for protesting the tax is the same for all businesses, regardless of size. The taxpayer must protest the

assessment within 45 days under KRS 131.110, which typically entails filing a written protest with the Department and may involve a protest conference with the Department in Frankfort. If the protest procedure does not resolve the assessment and the Department issues a final ruling, the taxpayer has the right to appeal to the Kentucky Claims Commission under KRS 131.340. A taxpayer may continue to pursue relief in Circuit Court and appeal to the Court of Appeals, etc. Obviously, due process is not free.

Unfortunately for small businesses, the economics often result in small businesses paying taxes that they may think that they do not owe for multiple reasons. First, the complexity of Kentucky tax laws sometimes makes it difficult for small businesses to determine what the “right” answer is so that they do not think they owe what they owe, think that they owe what they do not, or just plain do not know; sometimes, there is no black or white answer – only gray. Also, relatively small assessments, *e.g.*, $10,000, or less (which is a lot of money to you, me, and small businesses) may not cost justify paying a CPA, attorney, or attorney-CPA to assist them. So, they often either pay the assessment or try to fight it themselves. Conversely, large assessments which, for example, could result from a misunderstanding of the Kentucky tax laws such as a sales tax exemption can often threaten the small business as a going concern, forcing the small business to fight the assessment or “die” trying.

Officer Liability

Many small businesses set themselves up as limited liability companies under the impression that this insulates the managers of the LLC, which are often the owners, from *all* liabilities. However, the limited liability protection of an LLC is not unlimited. The obligation to collect withholding taxes and sales taxes carry with them the added burden of the potential for personal liability. So, small businesses should keep this in mind in prioritizing payments.

Take Away

Entrepreneurs running or employed by small businesses are often jacks of all trades. Successful small businesses thrive when they consistently make choices in which the benefits exceed the costs. In the context of tax compliance, this often requires a long-term view, since up-front costs of tax compliance should be looked at as investments.

This is a modified version of Mark A. Loyd’s regular column, *Tax in the Bluegrass*, “Kentucky tax challenges facing small businesses” which appeared in Issue 2, 2017 of the Kentucky CPA Journal.

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