

A look back: 2013 Kentucky tax highlights



By Mark A. Loyd,
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Looking back at 2013, there was a lot going on with Kentucky taxes. Although not as exciting legislatively as 2005 which brought us Kentucky Tax

Modernization or 2006 which saw

major revisions to certain 2005 Tax Modernization provisions, several significant developments have left their mark on 2013.

Limited Liability Entity Tax assessments

“Life can only be understood backwards; but it must be lived forwards.”

- Søren Kierkegaard.

The Limited Liability Entity Tax (LLET), a tax on the lesser of Kentucky gross receipts or gross profits, with a minimum tax of \$175, had its origins in the Alternative Minimum Tax of 2005 and was born of the 2006 amendments to Tax Modernization. Recall that the 2006 amendments fixed the problems created when Kentucky began taxing pass-through entities as if they were corporations, when they were not.

One of the most pervasive tax issues in recent years results from the Kentucky Department of Revenue's LLET compliance initiative. Many companies across the Commonwealth have been impacted by this.

The Department has been sending Notices of Tax Due to LLET taxpayers computing LLET using the gross profits method, disallowing the use of the costs of goods sold deduction entirely or certain deductions for costs to goods sold, generally allowing deductions only for materials and direct labor. The Department tends to disallow

cost of goods sold expenses classified as “other” or “miscellaneous” on the federal tax return. Consider a further breakout of these expenses on your tax return to address this. Should your company or your client receive a Notice of Tax Due for LLET, you should protest the assessment if you believe it to be inaccurate.

Post-Tax Amnesty

“When you walk out that door, so do words like ‘amnesty’ and ‘pardon’.”

- FBI Agent Luke Hobbs in *Fast & Furious 6* (2013).

In the fall of 2012, the Department conducted a Tax Amnesty Program, enacted by the General Assembly. The Tax Amnesty Program provided for a waiver of all penalties and a reduction of 50 percent of the interest owed. 2013 has seen the aftermath of Amnesty in the form of additional Amnesty penalties, called cost of collection fees, of 25 percent for Amnesty-eligible tax periods and transactions, generally those occurring prior to Oct. 1, 2011. The penalties increase to 50 percent for a taxpayer who failed to file a return. There is also a 25 percent penalty for taxes that become due and owing regardless of when they were due. Also, there is an additional 2 percent interest rate for Amnesty periods.

2013 Legislation

“Laissez-faire mon (mi) amour, c'est la vie.”

- From *Everything Goes To Hell*, Tom Waits (2002).

The 2013 General Assembly made relatively few changes to Kentucky's tax laws. Although many changes were proposed by the Blue Ribbon Tax Commission of 2012, a major overhaul of Kentucky taxes did not occur. There were, however, a couple



A medley of tax notes

of significant developments. For example, the disclosure and burden of proof standards for intangible expenses and interest expenses in KRS 141.205 were extended to management fees paid to a related entity, foreign corporation, or member of an affiliated group. Also, the General Assembly enacted a requirement that out-of-state retailers selling products for consumption or use inside Kentucky notify customers of each purchaser's obligation to report and pay Kentucky use tax.

Cox Interior

“Don't get discouraged, don't be afraid ...”

- From *Fight the Good Fight, Triumph* (1981).

In *Deptment of Revenue v. Cox Interior, Inc.*, 400 S.W.3d 240 (Ky. 2013), the Kentucky Supreme Court affirmed decisions of the courts below it, holding that a taxpayer's ability to seek a refund of a payment for a tangible personal property tax assessment is not conditioned upon first filing a protest of that assessment. The Department had adopted the practice of denying taxpayers' refunds based on its position in *Cox Interior*. This was a common practice, which would, based on this Opinion, be expected to end. The Court rejected the Department's position which required taxpayers to exhaust two administrative remedies, rather than the one, and would prevent a taxpayer from pursuing a valid refund claim if the taxpayer failed to protest the initial tax assessment.

Exemption for inventory to be shipped out of Kentucky

“Seems that the wrath of the gods got a punch on the nose....”

- From *Going to California*, Led Zeppelin (1971).

KRS 132.097 provides an exemption from state tangible personal property tax for property placed in a warehouse or distribution center for the purpose of subsequent shipment to an out-of-state destination as long as the owner can reasonably demonstrate that the property

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will be shipped out of Kentucky within the next six months. KRS 132.099 provides a similar exemption for local property taxes. In *Pinkerton Tobacco Co. v. Dep't of Revenue*, File No.: K-11-R-20, Order No. K-23033 (KBTA, Mar. 27, 2013), the Kentucky Board of Tax Appeals found that inventory was exempt from tax because the Taxpayer reasonably demonstrated that it would be shipped to an out-of-state destination within six months. The Department took issue with the fact that since the manufacturer lost control of the products once they were shipped to the purchaser, it could not reasonably demonstrate that the inventory was shipped out of state within the statutory six month period. The KBTA obviously agreed with the Taxpayer; however, the Department appealed the decision to the Franklin Circuit Court.

Recycling case reversed and review sought

“Just when I thought I was out... they pull me back in.”

- Michael Corleone in *The Godfather: Part III* (1990).

Kentucky provides a generous credit for recycling equipment. No Kentucky court had considered a case involving the credit statute, KRS 141.390, until *Department of Revenue v. Bavarian Trucking Co., Inc.*, No. 2011-CA-002198 (Ky. App. May 24, 2013). The Kentucky Court of Appeals reversed the decisions of the Circuit Court and the KBTA and held that equipment used in collecting methane gas collected from landfill waste and later burned to generate electricity was not eligible for the recycling equipment tax credit under KRS 141.390. Although both the Circuit Court and the KBTA agreed with Bavarian that all of its landfill equipment used in the methane collection process was eligible for the credit because it was used for recycling, the Court of Appeals found that the methane was not post-consumer waste, and therefore, the equipment was not eligible for the credit. Bavarian has petitioned the Kentucky Supreme Court for review. [Editor's Note: Bingham Greenebaum Doll LLP represents Bavarian in this matter].

Tollers and the Energy Exemption

“[A]ll energy is only borrowed, and

one day you have to give it back.”

- Jake Sully in *Avatar* (2009).

Kentucky provides a sales and use tax exemption for the cost of energy or energy-producing fuels used in the course of manufacturing, processing, mining or refining but only to the extent that the costs exceed 3 percent of a taxpayer's cost of production.

In *Ohio Valley Aluminum Co., LLC v. Dep't of Revenue*, Civil Action No. 12-CI-00368 (Shelby Cir. Ct. Feb. 21, 2013), the Shelby Circuit Court considered a case involving the energy exemption. Ohio Valley is a processor that heats scrap aluminum metal into aluminum billets at its Kentucky plant. In 2007, Ohio Valley restructured its business and created a wholly-owned subsidiary for the purpose of purchasing scrap aluminum and performing financial hedging and speculating as to aluminum prices. In connection with the restructuring, Ohio Valley transferred ownership of its inventory to its subsidiary; they entered into a tolling agreement, which provides that for a fee, Ohio Valley would process into billets aluminum scrap purchased and owned by its subsidiary. Based on the restructuring and tolling agreement, Ohio Valley argued that it was a toller, and like other tollers, Ohio Valley

did not have to include the cost of the scrap aluminum in its cost of production calculation for purposes of computing the energy exemption.

The Department disregarded the structure and asserted that the two companies were one operation at one plant facility so that Ohio Valley must include the cost of the subsidiary's materials in Ohio Valley's cost of production. The Shelby

Circuit Court affirmed the KBTA's decision which upheld the Department's denial of Ohio Valley's refund request that sought an exemption from Kentucky sales and use tax paid on the cost of energy used in its tolling operations. Ohio Valley has appealed to the Kentucky Court of Appeals. [Editor's Note: Bingham Greenebaum Doll LLP represents Ohio Valley in this matter.]

“It's not the destination so much as the journey, they say.”

- Jack Sparrow in *Pirates of the Caribbean: On Stranger Tides* (2011).

Undoubtedly new issues, challenges and opportunities will arise as we get further into 2014. Best of luck with them.

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