Kentucky tax issues for coal producers

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The Commonwealth of Kentucky has many things going for it: fast horses, bourbon, tobacco farms, and, of course, coal. Kentucky coal provides power for our homes, schools, offices and factories, and also provides jobs for many Kentuckians.

Coal operations

A coal operation (which includes the mine, the prep plant, and the load-out facility) is often highly automated and can be spread out over several miles. A typical coal mine operation involves the severance of coal from a surface or an underground mine, often accomplished by a continuous mining machine. That raw coal is then transported via a conveyor or truck to what is commonly referred to as a prep plant, which is encompassed by machinery comprised of a system of conveyors, screens, washers and crushers that act on the raw coal. It is then blended to each customer's specifications and transported, again, via conveyor or truck, to a load-out facility where it may be chemically treated and placed in railcars or barges for shipment to customers. The process details may differ depending on the specific coal operation, *e.g.*, depending on the distance between the mine, the prep plant and the load-out facility.

Coal tax

Kentucky's supply of coal is finite. So, unsurprisingly, the Commonwealth levies a coal tax on each taxpayer engaged in severing and/or processing coal within Kentucky for this privilege at a rate of 4.5 percent of the gross value of all coal severed and/or processed. *See* KRS 143.020. The coal's owner or the one with an economic interest in it is the taxpayer responsible for paying the coal tax; in contrast, one without title or economic interest, *e.g.*, a contract miner, is not a coal tax taxpayer. *See Dept. of Revenue v. Majestic Collieries Co.*, 594 S.W.2d 877 (Ky. 1979); *Vericoals v. Revenue Cabinet*, 869 S.W.2d 49 (Ky. 1949).

For purposes of computing the coal tax, "gross value" is the amount a taxpayer receives for the sale of severed or processed coal, less transportation expense. *See* KRS 143.010(6). Notably, gross value is statutorily defined by reference to the Internal Revenue Code as in effect on Dec. 31, 1977 – 35 years ago.

Gross value is generally the amount received or receivable by the taxpayer for coal sold during a reporting period. If there is no sale, then gross value is the contract price, or if there is no contract, it is the fair market value. When related parties are involved in a transaction,

continued on page 10

coal continued

the gross value is the amount received or receivable from the first non-controlled sale and if sold for consumption, the gross value cannot be less than fair market value. When coal is purchased for the purpose of processing and resale or consumption, the gross value is reduced by the amount paid or payable to the registered taxpayer that actually severed the coal.

Severance tax issues often, but not always, involve issues regarding determination of the amounts that are properly includable in gross value – or not. For example, non-mining expenses are not included. *See Revenue Cabinet v. Brown Badgett, Inc.*, 771 S.W.2d 819 (Ky. 1989). Another example of an amount that is not included is transportation expense.

Kentucky also imposes a severance tax on the severing or processing of natural resources within the Commonwealth. Although somewhat similar to the coal tax, nuanced distinctions exist. One example is the credit for limestone severed or processed within Kentucky and sold to a purchaser outside of Kentucky.

The state-only property tax rate and the sales tax exemption for coal production equipment

Coal production equipment can be expensive, sometimes costing hundreds of thousands or millions of dollars for a single machine. Consequently, whether the state-only ad valorem personal property tax rate for machinery actually engaged in manufacturing [KRS 132.200(4)] or

the sales and use tax exemption for machinery for new and expanded industry [KRS 139.480(10)] applies to a given piece of equipment can be an important issue to a coal company.

To obtain the favorable state-only property tax rate, the equipment at issue simply has to be machinery actually engaged in manufacturing. In contrast, the sales tax exemption for machinery for new and expanded industry applies to machinery: a.) used directly in a manufacturing or processing production process; b.) incorporated for the first time into a plant facility established in Kentucky; and c.) that does not replace machinery in the plant facility, unless the machinery purchased: increases the consumption of recycled materials at the plant facility by not less than 10 percent, performs different functions, is used to manufacture a different product, or has a greater production capacity as measured in units of production than the machinery being replaced.

The process of taking raw coal and turning it into a final marketable product is manufacturing. As a matter of historical interest, *T.T. Colley v. Eastern Coal Co.*, 470 S.W.2d 338 (Ky. 1971) held that for purposes of Kentucky property tax, a coal producer's process did not constitute manufacturing. But, this determination was overruled just a few years later in *Dept. of Revenue v. Allied Drum Service, Inc.*, 561 S.W.2d 323 (Ky. 1978). So, it is clear that coal production is manufacturing.

Issues with regard to the state-only property tax rate and the sales tax exemption often involve determining where the manufacturing process begins and where it ends. This plays a role in determining whether the involved machinery qualifies for the state-only property tax rate or the sales tax exemption.

The Department's most recent pronouncement regarding the state-only ad valorem property tax rate is set forth in Administrative Regulation 103 KAR 8:130. That Regulation provides definitions of manufacturing machinery and the processing area. Under the Regulation, machinery actually used in the crushing, sizing, blending, chemical treating, and washing of coal, *i.e.*, the conveyance of coal into the crushing, sizing, blending and washing facilities, is manufacturing machinery. The Regulation also defines the beginning and end of the manufacturing process, *i.e.*, the loading of coal for final transport to the end user. However, under the Regulation, machinery engaged in extraction kind of severance, dredging or mining of coal is not manufacturing machinery for property tax purposes.

With regard to sales tax, it should be noted that machinery for new and expanded industry includes machinery used in either a manufacturing or a processing production process. *Alcoa Mining Co. v. Dickerson*, 242 S.W.2d 744 (Ky. 1951), although a property tax case, may shed some light on this issue. In any case, these issues are best viewed through the lens of the integrated plant theory, initially articulated in *Schenley Distillers, Inc. v. Luckett*, 467 S.W.2d 598 (Ky. 1971).

"Give me enough coal to start another hell and keep it burnin'…" Legend of John Henry's Hammer by Johnny Cash (1963)

While back in John Henry's day, coal mining was a manual process, today it is highly automated – but still hard work. Tax issues involving coal operations can arise in various contexts, *e.g.* coal tax, property tax and sales tax. Despite the long history of coal production in Kentucky, tax issues continue to confront coal companies, especially as the production of coal has become more automated as it has evolved over the years.

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