

Update on important Kentucky tax cases



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The Board of Tax Appeals (KBTA) and the Kentucky Courts have been busy this year. Rather than providing an update on every case, I have tried to narrow it down to the most interesting.

Kentucky sales tax cases

In *Ohio Valley Aluminum Co. v. Dep't of Revenue*, the Kentucky Court of Appeals considered the application of the Kentucky sales tax energy exemption to a toller. Many manufacturers with factories in Kentucky have been keeping an eye on this case.

Ohio Valley is a processor that heats scrap aluminum metal into aluminum billets. The company entered into a tolling agreement with its wholly-owned subsidiary, OVACO. Ohio Valley processes aluminum scrap purchased and owned by OVACO, for a fee, into aluminum billets.

The energy exemption applies to the cost of energy or energy-producing fuels used in manufacturing, processing, mining or refining *that exceeds three percent* (3 percent) of the taxpayer's cost of production, determined according to accepted accounting principles and computed on the basis of plant facilities, including those costs normally incurred in the exempt activity. The energy exemption also applies to the utility gross receipts license tax for schools.

Ohio Valley took the position that, as a toller, it would not have to include the cost of the scrap aluminum from its cost of production in computing its energy exemption. The Department denied Ohio Valley's requests for sales tax refunds, arguing that OVACO was merely a paper or holding company required to include the costs related to the materials it processed.

In September 2014, the Court concluded that, "We hold that the Board [of Tax Appeals] was correct in concluding that Ohio Valley and

OVACO are, in fact, one entity for purposes of taxation and that the Board did not err in denying them recognition otherwise." In reaching its conclusion, the Court construed the statutes in this circumstance to require Ohio Valley to include in its cost of production costs of raw materials owned by OVACO and upheld the application of the substance over form doctrine. Ohio Valley has indicated that it intends to request the Kentucky Supreme Court to grant discretionary review.

Progress Metal Reclamation Co. v. Dep't of Revenue concerns the application of the industrial tool and supplies exemption from sales tax to purchases made by a company in the recycling and manufacturing scrap metal business. Both the Department and Progress Metal have appealed the Franklin Circuit Court's decision to the Court of Appeals.

The industrial tool exemption includes "hand tools such as jigs, dies, drills, cutters, rolls, reamers, chucks, saws, spray guns, etc. and tools attached to a machine such as molds, grinding balls, grinding wheels, dies, bits, cutting blades, etc." The Circuit Court affirmed the decision of the KBTA holding that a hammer pin, which is used to hold a hammer in place on a rotor that turns and breaks up metal, was not an exempt industrial tool. The Circuit Court adopted the KBTA's reasoning that the hammer pin merely attaches the hammer to the machine, does not come in contact with the metal and has to be replaced every few weeks; so, it was a "repair, replacement, or spare part," which is specifically excluded from the exemption.

The industrial supplies exemption applies to supplies such as "lubricating and compounding oils, grease, machine waste, abrasives, chemicals, solvents, fluxes, anodes, filtering materials, fire brick, catalysts, dyes, refrigerants, explosives, etc." The Circuit Court upheld the KBTA's determination that liquid oxygen used in an oxy-fuel torch cutting process to cut large pieces of metal was an exempt industrial supply.

In a case involving the pollution control exemption, the Department denied Eco Power's request for certification as a "pollution control facility" on the basis that the primary purpose of the equipment was not for pollution control, but rather



to demonstrate and market the product to customers. In *ECO Power Solutions (USA) Corp. v. Dep't of Revenue*, the KBTA held that air pollution control equipment used by the taxpayer for demonstration and marketing purposes qualified as a pollution control facility exempt from sales tax. The Franklin Circuit Court, however, reversed the KBTA in August 2014, and ECO Power has opted not to appeal.

Kentucky property tax cases

A pair of cases involve KRS 132.097 and KRS 132.099 which provide state and local personal property tax exemptions for

inventory in transit. These exemptions apply to property placed in a warehouse or distribution center for the purpose of subsequent shipment to an out-of-state destination, so long as the owner can reasonably demonstrate that the property will be shipped out of state within the next six (6) months.

In *Pinkerton Tobacco Co. v. Dep't of Revenue*, the Franklin Circuit Court held that tobacco manufactured and stored by Pinkerton was exempt because it reasonably demonstrated that its tobacco products would be shipped to an out-of-state destination within six months of manufacture. The Department did not appeal this case; so, it is now final.

The *Pinkerton* case may be contrasted with *Chegg, Inc. v. Dep't of Revenue*, which is now on appeal from the KBTA at the Franklin Circuit Court. Chegg rents textbooks to college students shipped from its Kentucky warehouse that are returned by students to the warehouse after each semester ends. Chegg sells the books to other students directly or by shipping them to a third party seller. The KBTA, agreeing with the Department, concluded that under Kentucky case law, property with a more or less permanent location in Kentucky has a taxable situs here and found that the textbooks did. The KBTA concluded that because the books were shipped back into Kentucky, the property tax

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exemption for property located in a warehouse or distribution center to be shipped out of state within six months did not apply.

Also in *Chegg*, the Department refused to waive penalties. And, the KBTA upheld that decision.

Rent A Center East, Inc. v. Dep't of Revenue, now on appeal at the Jefferson Circuit Court, involves a dispute regarding the value of property for ad valorem tax purposes. RAC owns a chain of retail stores across Kentucky and rents household items. For prior tax years, RAC and the Department had entered into a settlement agreement regarding the valuation of certain tangible personal property. RAC argued that their agreement should apply to the parties on a "going forward" basis. The Department disagreed.

Since the agreement did not state that it was a "going forward" agreement, the KBTA held that the agreement did not apply to future tax years. Additionally, the KBTA held that RAC failed to carry its burden of proving that the Department had over-valued the property at issue because RAC did not present a certified appraiser as a witness.

The KBTA also decided that the imposition of the omitted property tax penalty was justified as RAC did not exercise reasonable care and prudence when it took the tax advisor's advice to apply the settlement agreement on a "going forward" basis.

In *Wilson Equipment Co., LLC v. Dep't of Revenue*, now on appeal at the Franklin Circuit Court, the KBTA concluded that equipment rented by Wilson Equipment, a retailer, and held under floor plan financing, came within the sales tax exemption for "new farm machinery and other equipment held in the retailer's inventory for sale under a floor plan financing arrangement by a retailer" and was therefore exempt. The Department had disallowed the exemption, arguing that the exemption covered only new farm machinery and other farm equipment used in a farming operation. Taxpayer argued that "other equipment" is broad and includes any equipment.

Kentucky income tax cases

In *Bavarian Trucking Co. v. Department of Revenue*, the Kentucky Supreme Court declined to review the Court of Appeals' Opinion, which reversed the decisions of the Circuit Court and the KBTA, and held that equipment used in collecting methane gas generated by landfill waste which is later burned to generate electricity is not eligible for the recycling or composting equipment income tax credit under KRS 141.390.

KRS 141.390 provided a tax credit for certain expenses incurred in a recycling/composting process. This credit specifically applies to equipment purchased and used for recycling

or composting "postconsumer waste." KRS 141.390(1)(a) defines "postconsumer waste" as a "product...which has served its intended use, and which has been separated from solid waste for purposes of collection, recycling, composting, and disposition."

On appeal, the Court of Appeals found that methane is not "postconsumer waste" as it is not a product that has served an intended end use, and it cannot be separated from solid waste because, by its very nature, the methane does not exist until generated in the landfill by decomposition. As such, equipment purchased by Bavarian was not eligible for the KRS 141.390 recycling tax credit.

Dep't of Revenue v. AT&T Corporation (and Subsidiaries) concerns the old corporation income tax elective consolidated return rules of KRS 141.200. That statute, which was amended in 2005 as a part of Tax Modernization, then provided for the taxation of a corporation's affiliated group and allowed a corporation to elect to file a consolidated return that included the tax returns of its subsidiaries, except for corporations exempt under KRS 141.040. According to the Court of Appeals, KRS 141.040(1) applied, and under that provision, foreign corporations without property or employees in the Commonwealth could not be taxed and thus should not be included in the elective consolidated group. The Court of Appeals declined to



address AT&T's constitutional arguments. The Department has sought discretionary review from the Kentucky Supreme Court.

Open records

In *Sommer v. Kentucky Dep't of Revenue*, the Franklin Circuit Court held that final rulings of the Department of Revenue are public records subject to disclosure. Those appealed to the KBTA need not be redacted, but those not appealed to the KBTA must be redacted for the taxpayer's name, identifying number(s), address and business description. The case began when attorney Mark Sommer filed an open records request with the Department and ultimately filed a lawsuit in Circuit Court to try to get the final rulings; Tax Analysts intervened.

Notably, final rulings appealed to the KBTA are already public record. These can be obtained by filing an open records request with the KBTA.

This is the latest in a string of cases in which Kentucky Courts have consistently required tax administrators to release redacted tax documents, including: occupational license applications, *Kentucky County Fiscal Court v. Kentucky Enquirer*, and lists of utility license tax payers, *Department of Revenue v. Eifler*. The Court of Appeals has stated, "[T]he redaction of private information on...tax returns could be accomplished...." *Eifler, supra*. So, one could expect a similar result for final rulings.

Given the case law, it would seem that the Department has its work cut out for it in arguing against the release of final rulings. Should the Department

adopt the Indiana Department of Revenue's practice of releasing redacted final rulings as a matter of course?

“Oh please, dear? For your information, the Supreme Court has roundly rejected prior restraint!”
 Walter Sobchak in *The Big Lebowski* (1998).

These cases give us a window through which to view what's going on with Kentucky taxes. But, cases are just the tip of the iceberg. Only a very small percentage of tax matters are litigated. These are, however, a good representation of some perennial and some of the hot issues in Kentucky. Others, no doubt, will work their way to the KBTA and the Courts as well.

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