Takeaways from the Latest Kentucky Appellate Court Tax Decisions
Dentons SALT Insights

Over the last year, the Kentucky Supreme Court and the Kentucky Court of Appeals have issued several opinions involving taxes. Following are some takeaways:

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Contest Your Assessment in the State that Issued It, or Here, in Kentucky?

Typically, a taxpayer has to contest a tax assessment in the state that made the assessment. One creative Kentucky taxpayer contested their Ohio tax assessment in a Kentucky court.

Ohio issued a tax assessment against a taxpayer based in Kentucky, and the taxpayer sued Ohio and Ohio Tax Commissioner, Testa, in his official and individual capacities, in a Kentucky circuit court, seeking: (1) a declaratory judgment that it is not subject to Ohio's tax (specifically, the Ohio Commercial Activities Tax, or "CAT"); (2) monetary relief pursuant to 42 U.S.C. § 1983 for the forced collection of taxes not owed, in violation of the Ohio and U.S. Constitutions; and (3) a determination that it would be inequitable to require Great Lakes to defend an action in a foreign state. *Testa v. Great Lakes Minerals, LLC,* 2018-SC-000161-TG (Ky. Dec. 19, 2019), *petition for rehearing filed* (Ky. Jan. 8, 2020). Ohio moved to dismiss the complaint on the grounds of sovereign immunity, qualified immunity, comity, lack of personal jurisdiction, and failure to exhaust administrative remedies.

The Circuit Court denied the motion to dismiss, and Ohio appealed and moved to transfer jurisdiction over the interlocutory appeal to the Kentucky Supreme Court, which granted and then abated the appeal pending the Supreme Court of the United States' decision in *Franchise Tax Board of California v. Hyatt,* 139 S.Ct. 1485 (2019) ("*Hyatt III*"). Following

Hyatt III, the Kentucky Supreme Court reversed the circuit court, holding that the claims against Ohio should be dismissed based on sovereign immunity and against Testa based on comity. In short, the Kentucky Supreme Court said that a taxpayer has to contest an Ohio assessment in Ohio court.

Notably, the Court did not address the Section 1983 claim or the claim of inequitable treatment. The taxpayer has filed a petition for a rehearing.

A State Is Not Above Its Own Laws....

A University of Kentucky health care facility certified delinquent medical bills of an individual as an "agency" debt and referred same to the Kentucky Department of Revenue for collection. *Univ. of Kentucky v. Moore*, No. 2018-SC-000193-TG (Ky. Oct. 31, 2019). The individual sued UK and the Department in circuit court, arguing that UK was not an agency for purposes of the administrative debt collection statutory provisions, and the defendants argued that the individual had not exhausted her administrative remedies and that sovereign immunity barred the declaratory judgment action. In reviewing the two questions before the Court, the Kentucky Supreme Court held that UK was an executive branch agency, but "the state is not sovereignly immune from a declaratory judgment action." *Id.*

It will be interesting to see how the courts ultimately address the exhaustion issue.

A Prior Year Settlement May Not Be a Safe Harbor from Penalties.

It would seem logical that a taxpayer could rely on a prior settlement agreement with the Kentucky Department of Revenue as reasonable cause for taking a position consistent with the settlement. However, the Department did not agree with this logic, and neither did the Kentucky Court of Appeals. *See Rent A Ctr. E., Inc. v. Dep't of Revenue,* No. 2016-CA-000687-MR (Ky. App. May 24, 2019) (designated not to be published). This may be because the Department sent a letter to the taxpayer that stated that processing a return which used the prior settlement valuation methodology did not constitute acceptance of the taxpayer's valuation methodology. Perhaps, reliance on a prior settlement could under certain circumstances demonstrate reasonable cause? Regardless, other than prevailing on an issue so that no tax is due, one effective way to demonstrate reasonable cause is to show that the circumstance comes within the Department's penalty waiver regulation, 103 KAR 1:040.

Get Your Arguments In Early.

Sometimes taxpayers wait too long to make or raise their arguments, normally inadvertently. There are completely understandable circumstances in which this occurs; for example, a taxpayer may not itself be aware of arguments that can be raised, such as the application of an exemption or a favorable tax rate for a particular class of property. When a central argument is not raised, this can unfortunately result in a court not addressing the argument. *See, e.g., Rent a Ctr. E., supra.* As such, issues that are central to a tax protest should ideally be raised with the Department during protest or at least in the petition of appeal to the Kentucky Claims Commission. An ounce of prevention is worth a pound of cure, and in this regard, early identification of potential arguments facilitates resolutions of audits, protests and cases. There are, however, other ways to potentially deal with this depending on the circumstances.

Bring Your Best Game.

Particularly in the property tax context, a taxpayer must provide evidence to prove the assessment is wrong. This is because an "estimated property tax assessment [has] a presumption of validity and … the burden of establishing that the assessment is incorrect [is] on the taxpayer." *Gray v. Best*, No. 2018-CA-001395-MR (Ky. App. Sept. 27, 2019) (designated not to be published). So, when a taxpayer does not provide an appraisal or recent sales in support of the taxpayer's value, a taxpayer often cannot carry the burden. *See, e.g., Gray v. Best, supra, Rent a Ctr. E., supra.* Getting an appraisal and proffering same as evidence to the Kentucky Claims Commission (or submitting same earlier in the administrative process) is often necessary, but not essential, for a taxpayer to prevail when contesting a property tax value made by a Property Valuation Administrator or the Department of Revenue.

Revenue Laws Are Strictly Construed in Favor of Taxpayers, But….

For 10 years, a Tennessee resident maintained employment with his employer in Kentucky. *Ridge v. Dep't of Revenue,* No. 2018-CA-001517-MR (Ky. App. Aug. 16, 2019), *discretionary review requested* (Ky. Sept. 13, 2019). When his employment ended, he received a severance agreement which included a non-compete and non-solicitation clause. His employer withheld Kentucky state income taxes, and the taxpayer sought a refund on his return.

Although the Kentucky Court of Appeals rejected the Circuit Court's use of the standard of strict construction against exemption because the interpretation of revenue laws drove this issue so that all doubts were to be resolved in favor of the taxpayer. Irrespective of the deferential standard, the Court of Appeals held that, "severance pay constitutes 'wages' under the Internal Revenue Code (and therefore, by operation of KRS 141.010(9), under Kentucky statutory authority, as well), and is thus income…. The ability to earn that income was based on Ridge's employment in the Commonwealth…. Therefore, the income from this severance agreement was taxable pursuant to KRS 141.020(4) and its application to appellant was not unconstitutional." The taxpayer has appealed to the Kentucky Supreme Court.

It will be interesting to see whether the Kentucky Supreme Court decides to review this case. Given that many employers in Kentucky are located near the Commonwealth's borders, many employers employ nonresidents who often receive severance pay at the end of their employment.

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