Kentucky Tax Developments: Fall 2023

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I. 2023 Legislative Update

The Kentucky 2023 regular legislative session saw a number of important tax law changes.

Bourbon Barrel Tax Phase Out and Tax Credit

Notably for one of Kentucky's largest industries, the bourbon barrel tax and tax credit will be phased out.[1] Pursuant to House Bill 5 ("HB 5"), from 2026 through 2042, the tax rate will decrease by 4% to 7% per year until January 1, 2043; at which time, distilled spirits stored in or aging in barrels will be exempt from state and local ad valorem taxes.[2] Prior to January 1, 2040, taxpayers may elect to either (1) waive accumulated bourbon barrel tax credits and receive a nonrefundable and nontransferable tax credit for 25,000 barrels per year, or (2) waive future tax credits and receive a refundable credit on different taxes.[3] In addition to slowly eliminating the bourbon barrel tax, beginning on January 1, 2022, HB 5 provided for a refundable pass-through entity tax credit equal to 100% of the entity owner's proportionate share of the tax paid based on the pro rata share of the owner's income from the entity.[4]

[1] See KRS 132.140(2)(c) ("Distilled spirits stored or aging in barrels located in a bonded warehouse or premises shall be exempt from state and local ad valorem taxes for tax assessments made on or after January 1, 2043."); (3) ("The maximum state and local tax rate that may be levied on distilled spirits stored or aging in barrels located in a bonded warehouse or premises shall be as follows").

[2] See KRS 132.140(3)-(4) ("Distilled spirits stored or aging in barrels located in a bonded warehouse or premises shall be exempt from state and local ad valorem taxes for tax assessments made on or after January 1, 2043.").

[3] See KRS 141.389(2)(b) ("A taxpayer may make an election regarding the distilled spirits tax credit related to taxable years beginning on or after January 1, 2024, but prior to January 1, 2040. The election shall be to: (1)(a) Waive any accumulated amount of tax credits; and (b) Be allowed a nonrefundable and nontransferable tax credit up to twenty-five thousand barrels… for each taxable year…. or (2)(a) Waive all future tax credits allowed under this section; and (b) Be allowed a refundable tax credit on multiple taxes as described in subsection (7) [which imposes several requirements for eligibility.]").

Reduction of Individual Income Tax Rate

House Bill 1 ("HB 1") reduced the individual income tax from 5% to 4.5% for the 2023 tax year and 4% for tax years beginning in 2024. This is part of a concerted effort to eliminate Kentucky's individual income tax. Future years may see more bills like HB 1 that reduce the income tax by 0.5% per year, provided that the budget reserve trust fund is at least 10% of the previous year's tax revenue and the general fund is sufficient to cover any lost revenue due to the reduced tax rate.[5]

Finally, Senate Bill 112 ("SB 112") expands the confidentiality exemptions and permits county employees to disclose certain taxpayers' information when requested for an audit or when the information is part of the public record.[6] Consequently, when requested by a tax official, a county employee must provide the requested information which might include a taxpayer's tax schedules or returns or information concerning an investigation into the taxpayer's business.[7]

Pass-through Entity Tax Election

On March 24, 2023, Kentucky Governor Andy Beshear signed into law House Bill 360 (HB 360), amended by House Bill 5 (HB 5), which created a pass-through entity tax and tax credit, joining its sister states that have enacted SALT parity legislation. What is Kentucky's pass-through entity tax, and how does it affect your company? With the 2022 tax filing deadline looming, read on to learn more.

Background: The Tax Cuts and Jobs Act SALT Cap

The 2017 Tax Cuts and Jobs Act (TCJA) limited the available individual itemized federal income tax deduction for state and local taxes paid during a tax year to $10,000, which impacted individuals and complex, non-grantor trusts. The "SALT Cap" is in effect until 2026.

However, the Internal Revenue Service's Notice 2020-75 approved a workaround for pass-through entity taxes: in computing its taxable income, partnerships and S corporations may deduct any state and local tax payments paid at the entity level, thereby allowing its owners to take advantage of a full deduction.[8] As a result, many states have enacted "pass-through entity tax" legislation, often referred to as SALT parity legislation, that allows certain taxpayers to reclaim some of the previously-available federal deduction for state and local taxes paid. During the 2023 legislative session, Kentucky enacted its answer to the SALT Cap.

Kentucky House Bill 360

HB 360 provides that "For taxable years beginning on or after January 1, 2022, a pass-through entity may elect to pay the tax liability at the entity level". The election must be: (a) made on a form prescribed by the Kentucky Department of Revenue, (b) made by April 15th (or, if there is an extension, October 15th, though under HB 5, 2022 elections must be made before August 31, 2022), (c) made with the consent of all individuals with over 50% ownership in the entity, and (d) binding upon all individuals in the entity. If such election is made, the pass-through entity must report each individual owner's proportionate share of the tax paid by the entity to the individual. But, there is a nonrefundable tax credit equal to the entire amount of the tax paid by the pass-through entity on behalf of such individual, based on the pro rata share of the individual's income from the entity.

HB 360 allows pass-through entities to elect to pay Kentucky income tax at the entity level. The taxes paid by the entity would then be deducted at the entity level, which will then flow through without limitation to the shareholders or owners of the entity. This replaces some portion of the individual itemized deduction for state and local taxes that would otherwise be unavailable as the result of the SALT Cap. And, because this tax election is retroactive, Kentucky taxpayers may also elect to use the pass-through entity tax election for the 2022 tax year.

HB 5 amended HB 360 to better align with Notice 2020-75 and make the pass-through entity tax credit refundable. Following HB 5, an election for the 2022 tax year may be made any time before August 31, 2024 without incurring a late penalty,[9] and electing entities do not need to estimate the income tax payments for the 2022 and 2023 tax years, nor will there be a tax penalty assessed for those tax years.[10] HB 5's changes are effective as of March 31, 2023.[11]

[4] See HB 5 (creating a new section 9) ("For taxable years beginning on or after January 1, 2022, there shall be allowed a refundable pass-through entity tax credit which shall be: (a) Equal to one hundred percent (100%) of the entity owner's proportionate share of the tax paid by the pass-through entity for the taxable year; (b) Claimed against the tax imposed under KRS 141.020 on a return filed by the entity owner… and (c) Based on the pro rata share of the entity owner's income from the pass-through entity.").

[5] See KRS 141.020(2)(a)(5) ("'Reduction conditions' means: The balance in the [budget reserve trust fund] at the end of a fiscal year shall be equal to or greater than ten percent (10%) of the [receipts deposited in the general fund] for that fiscal year; and [such receipts] at the end of a fiscal year shall be equal to or great than GF appropriations for that fiscal year plus the [amount of reduction in the receipts resulting from the reduction in tax rate] equivalent for that fiscal year").

[6] See KRS 67.790(8)(a) ("No present or former employee of any tax district shall intentionally and without authorization inspect or divulge any information acquired… This prohibition does not extend to:… (2) Information that is in any way made a matter of public record; (3) Information requested for audit purposes by a taxing jurisdiction").

[7] See id. ("No present or former employee of any tax district shall intentionally and without authorization inspect or divulge any information acquired by him or her of the affairs of any person, or information regarding the tax schedules, returns, or reports required to be filed with the tax district or other proper officer, or any information produced by a hearing or investigation, insofar as the information may have to do with the affairs of the person's business.").

[8] See Notice 2020-75, IRS, https://www.irs.gov/pub/irs-drop/n-20-75.pdf ("Congress provided that 'taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law.'").

[9] See HB 360 ("For taxable years beginning on or after January 1, 2022, but before January 1, 2023: (1) The election may be made after March 31, 2023, but shall be made before August 31, 2024; (2) As a result of the electing entity making the election as described in subparagraph 1 of this paragraph: (a) No late payment, late filing, or other similar penalty under KRS 131.180 shall be imposed on an electing entity; and (b) No interest under KRS 131.183 shall apply to the tax paid by the electing entity.").

The Logistics

Though there is a large potential upside for many Kentucky taxpayers with an interest in a pass-through entity, the entities themselves are faced with making a quick decision as the April 17 tax filing deadline rapidly approaches (and, the filing deadline for pass-through entities to file their federal income tax return passed on March 15). Though HB360 has set the gears in motion for the pass-through entity tax election, many of the practicalities of effectuating such election have yet to be put in place. For example, the Kentucky Department of Revenue has not yet created the form for the pass-through entities to make the election, as required by the statute.

As an entity-level tax, the decision to make the election may also be complicated. Entities doing business in multiple states will need to understand how the addition of paying Kentucky state tax may impact their tax liabilities, deductions, and credits in all jurisdictions where they file. And, though the tax is paid at the entity-level, the positive impact is seen on the shareholder/owner level. As each individual taxpayer has a different filing situation, however, the pass-through entity tax may not affect everyone equally. Pass-through entities with only a few owners or shareholders may be able to work through these differences and considerations in time to make the election, but entities with a large number of shareholders must make a judgment call. Of course, taxpayers may choose to extend their returns to give them additional time to review their options and to await further guidance from the Department; many taxpayers are taking this route.

What's Next?

As noted above, unless Congress steps in, the SALT Cap will sunset in 2025. To date, there have been a few bipartisan legislative proposals introduced in Congress in an effort to repeal or soften the SALT Cap. Taxpayers or their tax advisors should review their individual tax situations and the implications of HB360 and the SALT parity acts of other states for the entities in which they have an interest to make informed decisions.

Expanded Sales Taxes Now In Effect

As part of the effort to phase out the Kentucky individual income tax, in April 2022, Kentucky House Bill 8 ("HB 8") passed – over the Governor's veto – and expanded the sales and use tax base to include over 30 consumer and business-to-business services, with an emphasis on short-term services. The new taxes take effect on January 1, 2023. These changes follow the nationwide trends to expand consumer taxes, often by taxing services, and cut income taxes.

The Kentucky Department of Revenue ("KDOR") has provided some informal guidance on the substantial changes made by HB 8; however, many questions remain unanswered, including practical issues in compliance.

Services Now Subject to Kentucky's Sales and Use Tax

- The newly taxable services are:
- photography and photofinishing services;
- telemarketing services;
- public opinion and research polling services;
- lobbying services;
- executive employee recruitment services;
- website design and development services;
- website hosting services;
- facsimile transmission services (currently taxable as communication services);
- private mailroom services;
- bodyguard services;
- residential and non-residential security system monitoring services;
- private investigation services;
- process server services;
- repossession of tangible personal property services;
- personal background check services;
- parking services that are not located at an educational institution;
- road and travel services provided by automobile clubs;
- condominium time-sharing exchange services;
- rental of space for short-term business uses, entertainment events, and short-term social events (i.e., a rental for less than 30 days);
- social event planning and coordination services;
- leisure, recreational, and athletic instructional services;
- recreational camp tuition and fees;
- personal fitness training services;
- nonmedical massage services;
- cosmetic surgery services;
- body modification services;
- non-medical, non-educational, non-veterinarian, and non-government or court ordered testing services;
- interior decorating and design services;
- household moving services;
- specialized design services;
- lapidary services;
- labor and services to repair or maintain commercial refrigeration equipment and systems when no tangible personal property is sold in that transaction;
- labor to repair or alter apparel, footwear, watches, or jewelry when no tangible personal property is sold in that transaction;
- and prewritten computer software access services.

The $6,000 de minimis threshold in KRS 139.470(23) applies to these newly taxable services.

Businesses selling these high growth, high consumption

[10] See id. ("For taxable years beginning on or after January 1, 2022, but before January 1, 2024, an electing entity is not required to make estimated income tax payments and no estimated tax penalty shall be assessed under KRS 141.985.").

[11] See id. ("Whereas an election for pass-through entity taxation provides a necessary option for [owners] currently filing tax returns… an emergency is declared to exist, and this Act takes effect upon its passage and approval by the Governor or upon its otherwise becoming a law.").

services must now register with KDOR and collect the 6% sales tax from their customers. Taxable service providers are required to file monthly or annual returns and remit the tax.

Businesses should be careful to understand which charges associated with a taxable service are the responsibility of the service provider versus those charges that are passed on to the customer. Service providers may, in some instances, issue a resale certificate for the purchase of tangible personal property that transfers to the customer. For example, an interior designer may issue a resale certificate for the purchase of tangible personal property that transfers to the customer, e.g., drapes, blinds, and wallpaper. However, if the interior decorating and design provider performs a turn-key project and bills for all project charges, then the bill is subject to the 6% sales and use tax. For example, improvements to real property performed by or on behalf of the interior decorator, that is billed to the customer, is considered the taxable retail sale of the interior decorator's services.

Following the trend in expanding taxable transactions, HB 8 changed the definition of "extended warranty services" to include warranty contracts for real property and all contracts for tangible personal property and digital property—regardless of whether the property is taxable or exempt. For example, a separately charged extended warranty on farm equipment (an exempt property) will no longer be exempt from sales and use tax. However, if the extended warranty was purchased by a tax-exempt purchaser, then it may still be exempt from the sales and use tax. HB 8 also amended the exemption from sales and use tax for residential electricity, natural gas, fuels, water, and sewer services to require the service be declared by the resident as used in the resident's domicile.

The Trend Toward Taxing Services

There are a few notable trends among the newly taxable services.

Internet-related services appear to be a target among the newly taxable services. These include telemarketing services; website design and development services; website hosting services; and prewritten computer software access services.

Kentucky's changes are in line with the recent nationwide tax trends. According to the Tax Foundation[12], Kentucky is among thirty-eight states that had noteworthy tax changes take effect on January 1, 2023. However, while it follows the recent nationwide trend of income tax rate deductions, Kentucky's recent tax changes break from the pack in a few ways. Specifically, of the eleven states that had individual income tax rate reductions take effect, Kentucky is the only one to pay for the reductions by expanding its sales tax to select services.

These changes allow Kentucky to obtain revenue from previously unavailable sources of tax revenue. Take for example the newly taxable lobbying services. According to KDOR, the sales and use tax on lobbying services is based on where the customer receives the service. [KDOR Tax Answers, Lobbying Services (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Lobbying-Services.aspx)]. Accordingly, a lobbying provider located in Washington, D.C. lobbying on behalf of a Kentucky client would charge the Kentucky sales and use tax because the client is receiving or making first use of the service in Kentucky. Previously, Kentucky likely could not obtain tax revenue from such a transaction unless it could show the D.C. based lobbying provider owed Kentucky income taxes. Now, these tax changes allow Kentucky to tax the money leaving the state in this scenario by shifting the source from where the service is performed to where the benefit is received. The new taxes thus bring up thorny questions of nexus and other constitutional concerns.

The wedding industry is among the industries that are most heavily impacted by these changes. Specifically, by expanding the sales and use tax base to include lapidary services, social event planning services, specialized design services, photography services, and rental of space for weddings (and other short-term uses), the sales tax now applies to transactions for services concerning the purchase of engagement and wedding rings, wedding planners, the designing of wedding dresses, engagement and wedding photographs, and rental for the wedding reception, respectively. As with many of the newly taxable services, these wedding-related services often also involve the sale of tangible personal property, and service providers will need to be circumspect in creating correct invoices and charging the proper sales tax.

II. Executive & Administrative Updates

KDOR has provided guidance on the new taxes in Kentucky Sales Tax Facts (June 2022), Kentucky Sales Tax Facts (September 2022), Kentucky Sales Tax Facts (December 2022), and Kentucky Sales Tax Facts (June 2023), which can be accessed at https://revenue.ky.gov/News/Publications/Pages/Sales-Tax-Facts.aspx . Additional guidance may be found at TaxAnswers.ky.gov. The guidance tackles some of the specific services included in HB 8, but it does not address them all.

However, many questions remain unanswered. HB 8 includes specific statutory definitions for only some of the additional services, thus leaving several of the newly taxed services undefined. In such instances, KDOR appears to endorse dictionary definitions. [See, e.g., KDOR Tax Answers, Lobbying Services (explaining that while there is no definition of lobbying services in KRS Chapter 139, "Webster's Dictionary provides helpful guidance.") (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Lobbying-Services.aspx)]. While the guidance sheds light on compliance issues for some of the newly taxable services, taxpayers will likely have to wait for fulsome regulations in order for all of their questions to be addressed.

[12] State Tax Changes Taking Effect January 1, 2023, Katherine Loughead, Janelle Fritts, Timothy Vermeer, and Adam Hoffer (December 22, 2022) (available at https://taxfoundation.org/2023-state-tax-changes/#Kentucky).

KDOR has provided guidance for a few specific industries, described below.

Space Rental Services[13]

The taxation of the subrental of space for short-term business uses and short-term social events is shifted to the primary lessee and lessor. The new provision allows an event organizer to pay the sales tax for the space rental, thereby removing the requirement to collect tax from individual vendors or exhibitors. When the event organizer is also a nonprofit organization, the event organizer must pay the tax on charges under the primary lease to qualify for excluding the tax from the sublease or subrent of space.

Repair and Alteration Services

KDOR states that apparel, footwear, watches, or jewelry repair or alteration service charges—where the material used for the repair or alteration is less than 10% of the total charges—are taxable because the transaction is no longer bundled (i.e., both the materials used and the labor charges are taxable). Similarly, repair or maintenance charges on commercial refrigeration equipment and systems—even if the installed parts are less than 10% of the total charge—are taxable. The commercial refrigeration tax only applies to the repair and maintenance; it does not apply to the sale and installation of new commercial refrigeration equipment. The tax treatment of an original installation is dependent on whether the equipment and system will be fixtures to real property or will be free standing tangible personal property post-installation.

Parking Services[14]

KDOR also specified that charges for street parking and parking provided by city, county, and state governments or nonprofit entities are subject to the new parking services sales and use tax. If the customer receives a receipt, then the parking service provider must display the amount of sales tax collected on the transaction. If receipts are not available or the parking service is coin-only meters or cash-only lots, then the tax may be added to the sales price as one charge. Lastly, although parking services at educational institutions are exempt from the tax, parking services for athletic events occurring off of the campus is subject to the tax.

Residential Utility Exemption[15]

Pursuant to HB 8 residential utility services furnished to any non-primary residence location is subject to the Kentucky sales and use tax. Local utility companies became responsible for enforcing the new state tax law and have asked customers with more than one residential address to file a declaration of domicile form to continue receiving the sales tax exemption. Following confusion around what the new tax applies to and how to qualify for the residential utility exemption, KDOR updated its guidance and established a standardized form for residents to declare their eligibility. Utility companies must obtain the Declaration of Domicile for Purchase of Residential Utilities, Form 51A380 (Declaration of Domicile),[16] for any account designated as residential when the account holder changes or a new account is established. Since any uncertainty regarding the status of an account must be justified by the utility company via the Declaration of Domicile, it is important that each utility provider maintains its own records to provide justification for the residential utility exemption.

The owner or operator of a multi-unit residential facility may make the declaration of domicile to qualify for the sales and use tax residential use exemption for services under a master meter on behalf of the residents.[17] The residential exemption may also be claimed by a master meter that includes common service to common areas up to 10% of the total metered usage.

Recreational Vehicle Camper Trailers[18]

Effective March 24, 2023, recreational vehicles (RV) are subject to the motor vehicle usage tax regardless of whether the vehicle is non-motorized. Instead of retailers collecting the 6% sales tax on the sale of RV camper trailers when selling to an in-state resident, the 6% motor vehicle usage tax will be paid at the county clerk's office when presented for licensing and titling. KDOR will send additional guidance directly to dealerships and county clerks to accommodate the shift from sales and use tax to motor vehicle usage tax. This change does not affect the collection of sales tax on regular bumper hitch trailers designed for general hauling.

Employer Recruitment Services[19]

Another new taxable service is the sale of executive employee recruitment services. In establishing the scope of the new taxable service, KDOR incorporated the definition of an "executive employee" from IRS guidelines for highly compensated employees and the common definition of "executive." [See Section 414(q)(2) of the Internal Revenue Code of 1986]. Now, recruitment services for placement of a highly compensated employee who is an administrator or manager for a Kentucky employer and who makes $150,000 for tax year 2023, is considered an "executive employee" for purposes of HB 8.

[13] KDOR Tax Answers, Rental Space. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Rental-Space.aspx).

[14] KDOR Tax Answers, Parking Services. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Parking-Services.aspx).

[15] Discussed at length in KDOR's Kentucky Sales Tax Facts (December 2022 and June 2023)). (available at https://revenue.ky.gov/News/Publications/Sales%20Tax%20Newsletters/Sales%20Tax%20Facts%202022%20-%20Dec.pdf and https://revenue.ky.gov/News/Publications/Sales%20Tax%20Newsletters/Sales%20Tax%20Facts%202023%20-%20June.pdf respectively). See also, KDOR Tax Answers, Residential Exemption Changes. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Residential-Exemption-Changes.aspx).

[16] The form is available at https://revenue.ky.gov/Forms/51A380%20%281-3-23%29.pdf .

[17] The form is available at https://revenue.ky.gov/Forms/51A381%20(1-3-23).pdf .

[18] KDOR Tax Answers, Recreational Vehicles. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Recreational-Vehicles.aspx) .

Providers of executive employee recruitment services are liable for sales and use tax on the gross receipts from the provision of such recruitment services and must report the receipts on its sales and use tax return and remit the tax by the 20th day of the month after the month in which the services were provided and receipts recorded. If a contract penalty results in a reduction in receipts, then the provider may deduct the same way returned merchandise deductions work. Bonuses that are paid as part of the consideration for the services are also subject to the tax. If the provider bills a lump sum amount that includes executive employee recruitment services, without separating the charges from services not subject to sales and use tax, then the entire invoice is subject to sales and use tax.

Executive employee recruitment services provided by out-of-state parties can be subject to Kentucky sales and use tax. The sales and use tax on services is based upon where the customer receives the service. Therefore, if an out-of-state service provider provides executive employee recruitment services for a Kentucky company, the charges are subject to Kentucky tax. For example, headhunters and recruiters are included to the extent that they provide recruitment services for Kentucky clients.

Lobbying Services[20]

Lobbying services performed at the local, state, or federal levels are subject to Kentucky sales and use tax and the tax must be itemized. KDOR uses Webster's Dictionary's definition and defines "lobbying" as to promote or secure the passage of legislation or to attempt to influence a public official or servant toward a desired action. As with executive employer recruitment service providers, lobbying service providers are liable for sales and use tax on the gross receipts from the provision of such services and if the invoice is not itemized to separate the taxable services from the nontaxable services, then the entire invoice is subject to tax.

Because the sales tax on lobbying services is based on where the customer receives the service, a lobbying provider in Washington, D.C. lobbying on behalf of a Kentucky client would charge the Kentucky sales and use tax. However, if lobbying services are provided by employees of a company or trade group with their own staff lobbyists under the direction and supervision of their employers, then there is no retail sale of lobbying services and therefore it is not subject to tax. This is due to the fact that consideration subject to sales and use tax does not apply to salaries paid to individual employees for performance of job duties or to membership dues collected by trade groups.

Massage Services[21]

Providers of medically necessary massage services must receive documentation from a licensed medical practitioner authorized to prescribe the medically necessary massage services in order for the services to be exempt. For example, if a chiropractor refers a patient to a massage service provider, then the services are not subject to tax. On the other hand, if an athletic trainer or physical therapist prescribes the massage, then the services are taxable because neither qualify as a "licensed medical practitioner." Furthermore, the prescription must specify the dates or timeframe for the medically necessary massage services and the massage provider should maintain documentation of the medically necessary services rendered.

The purchase of gifts cards or gift certificates exclusively for massage services is a taxable purchase because the gift card or gift certificate grants the right to a taxable service. If the gift card or certificate is for a specific dollar amount and may be redeemed for various services or products, then the tax is imposed at the time of redemption based on the types of services or products purchased. If the gift card or certificate is designated exclusively for massage services and the purchase is at a Kentucky massage service provider or, if purchased online, the services are delivered to a Kentucky address, then the transaction is subject to Kentucky tax. Even if the massage services are provided by students in training at a public clinic, the provision of non-medically necessary massage services are subject to tax.

Recreation and Fitness Services[22]

Generally, leisure and recreational or athletic instructional services with a physical activity component are subject to tax, whereas services broadly categorized as the arts are not subject to the new tax. KDOR's examples of the former are:

- sports leagues with coaching
- baseball training
- basketball training
- cheerleading training
- football training
- golf lessons
- tennis lessons
- riding lessons
- gymnastics training
- martial arts classes
- skating lessons
- swimming lessons

In addition to the above, KDOR specified that, regardless of the type of organization providing personal fitness training services, receipts from such provision is taxable. Therefore, although the exemptions from sales and use tax for sales of admissions and fundraising events by non-profit organizations remains in place, HB 8 expressly imposes sales and use tax upon receipts from "personal fitness training services" without exception.

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[19] KDOR Tax Answers, Employer Recruitment Services. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Employer-Recruitment-Services.aspx).

[20] KDOR Tax Answers, Lobbying Services. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Lobbying-Services.aspx).

[21] KDOR Tax Answers, Massage Services. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Massage-Services.aspx).

[22] KDOR Tax Answers, Recreation and Fitness Services. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Recreation-and-Fitness.aspx).

Examples of the services that are not subject to sales and use tax are:

- art lessons
- craft and decorating classes
- life coaching sessions
- music lessons
- pilot training
- theatre classes
- vocational training
- legal, accounting, medical, or other professional certification training

Due to the overlap between the two categories that childcare services and camps provide, KDOR specified where the line is to be drawn. Generally, receipts from childcare services are not subject to sales and use tax. Unlike with the more business-to-business services, such as lobbying and employer recruitment services, providing a lump sum invoice to childcare customers will prevent the services from being taxed. In essence, if recreational or athletic instructional services provided by a licensed childcare facility are billed separately from the childcare services provided, then the instructional services are subject to the tax.

The line for camps is more black and white: if a camp has recreation as more than 10 % of the planned activities, the tuition for the camp is taxable—regardless of whether the camp is for-profit or non-profit, or whether the camp is a day camp or an overnight camp. However, sports camps operated by elementary or secondary schools or nonprofit elementary or secondary school-sponsored clubs, organizations, or affiliated groups are not taxable under recreational camp tuition fees if the net proceeds from the camp charges are only used for the benefit of the school or its students. This is likely due to the connection between childcare services and elementary or secondary school camps as a provider of family service during the work week; whereas a camp is more related to association and outdoor entertainment.

Civic and Nonprofit Organizations

KRS 139.498 now includes a sales and use tax exemption for nonprofit or civic organizations that sell concessions for leisure, recreational, or athletic fundraising purposes, provided the organization operates solely with volunteers for the fundraising event. The exemption also applies to leisure, recreational, or athletic services sold by such organizations. This excludes 501 (c)(3) and school organizations, which are already exempt under KRS 139.497.

Cosmetic Surgery Services[23]

Lastly, KDOR specified what operations count as cosmetic surgery services. In addition to the traditional cosmetic surgeries such as Botox injections and body sculpting procedures, KDOR's examples of cosmetic surgery services also include face and skin-enhancing procedures such as chemical peels, dermal fillers, teeth whitening, and tattoo removal.

Due to the nature of certain cosmetic surgery services, it does provide for resale; items to be administered to the patient or that will remain with the patient are eligible to be included on a resale certificate at the time of purchase. The cosmetic surgery provider should issue the Resale Certificate, Form 51A105, or the Streamlined Sales and Use Tax Certificate, Form 51A26, for the eligible purchases. Eligible items include non-exempt drugs, surgical sutures, materials for injection, or other similar items administered to the patient in providing cosmetic surgery services. However, a cosmetic surgery service provider's surgical tools, equipment, or any items consumed or used when providing the cosmetic surgery services are not eligible for exemption and are taxable retail sales transactions.

Unlike with executive employee recruitment services and lobbying services, which provide that itemizing the services prevents the lump sum from being taxed, the stated charges by a cosmetic surgery provider are all taxable as costs of the cosmetic surgery or as services necessary to complete the sale of the cosmetic surgery. However, if there are split billings, with one medically necessary surgery and one cosmetic surgery, separate billings that clearly delineate the medically necessary procedure and the related costs are not taxable and are excluded from cosmetic surgery services. Moreover, if charges for treatment costs associated with cosmetic surgery services are billed and collected separately by third-party medical providers, then they are not included in the gross receipts of the cosmetic surgery service provider and therefore not subject to sales and use tax.

Software as a Service

Prior to July 1, 2004, the statutory definition of tangible personal property for sales tax purposes did not include prewritten computer software. That changed in 2003 when Kentucky enacted 2003 H.B. 293 to adopt the streamlined Sales and Use Tax Agreement, effective July 1, 2004. H.B. 293 amended the definition of tangible personal property to tax such property regardless of the method of delivery and to specifically provide that tangible personal property includes prewritten computer software, and it also provided a statutory definition of prewritten computer software. Note that computer software other than prewritten computer software, such as customized software and separately stated charges for modifications or enhancements continue to be not subject to Kentucky sales tax. KRS 139.010(32).

What is the big issue with prewritten computer software now? It is prewritten computer software access services, which is one of the services made subject to sales tax by 2022 H.B. 8. Notably, unlike downloaded prewritten computer software which is taxed as tangible personal property, prewritten computer software access services are taxed as services. KRS 139.200(2)(ay).

Prior to H.B. 8, Were Prewritten Computer Software Access Services Subject to Sales Tax?

Unlike prewritten computer software transferred in tangible from (*e.g.*, on a disk) or downloaded to a computer or server

[23] KDOR Tax Answers, Cosmetic Surgery Services. (available at https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Cosmetic-Surgery-Procedures.aspx).

in Kentucky, Software as a Service (SaaS) was not subject to Kentucky sales and use tax; prior to H.B. 8, the Department of Revenue's position was:

Software as a Service (SaaS) that is not delivered into this state is not subject to Kentucky sales and use tax. If the software is accessed exclusively via the "cloud" or on-line exclusively via the selling entity's server, the software access is not subject to Kentucky sales and use tax. Software accessed via servers and in no way downloaded to the customer is not a retail sale of tangible personal property subject to Kentucky sales and use tax.

Ky. Dep't of Revenue, Kentucky Sales Tax Facts (Dec. 2020). The Department confirmed its position regarding SaaS in Private Letter Ruling KY-PLR-21-01:

The Taxpayer provides its Service via a SaaS model. With this charge for access and use of the Taxpayer's Software, there is no transfer or sale of tangible personal property. The prewritten computer software is a web-based SaaS model with no download of the Core Functionality.

The question here is whether the Taxpayer's subsequent free offer of a downloadable Application, with limited functionality that enhanced the usefulness of the Taxpayer's Software, changes the original exempt nature of the SaaS product for Kentucky sales and use tax purposes. The downloadable application for optional use by customers to record and upload Customer Information into the System is prewritten computer software.

The Taxpayer's offering of an Application that is pre-written computer software as part of the Service, which remains accessible online under the SaaS model, does not create a transaction subject to Kentucky sales and use tax. Furthermore, this provision of a pre-written computer software component with the SaaS model does not constitute a bundled transaction since the free software application is a de Minimis component of the Taxpayer's overall product provided to its customers.

When Kentucky did not tax SaaS prior to H.B. 8, it was aligned with the majority of states that do not tax SaaS. Only a minority of states, less than 20, tax SaaS; Kentucky joined the minority in 2023 by subjecting prewritten computer software access services to Kentucky sales tax.

What Are Prewritten Computer Software Access Services?

Unfortunately, as of February 2023, there is no guidance on the Kentucky Department's position regarding prewritten computer software access services.

According to the statutory definition, "prewritten computer software access services" means "the right of access to prewritten computer software where the object of the transaction is to use the prewritten computer software while possession of the prewritten computer software is maintained by the seller or a third party, wherever located, regardless of whether the charge for the access or use is on a per use, per user, per license, subscription, or some other basis…." KRS 139.010(33).

What May Be the Big Sales Tax Issues in regard to Prewritten Computer Software Access Services?

Is the Object of the Transaction to Use Prewritten Computer Software?

The true object test or essence of the transaction test has been employed in Kentucky to determine the object of the transaction. An example of this analysis may be found in WDKY-TV, Inc. v. Revenue Cabinet, 838 S.W.2d 431 (Ky. App. 1992) in which the sales tax issue involved WDKY's purchases of taxable videotapes and nontaxable intangible broadcast rights.

In the context of prewritten computer software access services, this would logically involve at least two inquiries.

First, is the object of the transaction prewritten computer software or non-prewritten computer software? The former being subject to sales tax and the latter being not subject to tax. By analogy, software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to that purchaser are not prewritten computer software, nor are separately stated modifications and enhancements. KRS 139.010(32). So, logically, that would also hold true for prewritten computer software access services.

Second, is the object of the transaction to use prewritten computer software or something else, like a non-taxable service or intangible? In Kentucky Tax Alert, Vol. 22, No. 5, (Sept. 2003), the Department recognized that the Kentucky Board of Tax Appeals employed the true object test in a case originating in 1999 to determine that a taxpayer was purchasing information, which was not subject to sales tax.

Accordingly, the object of the truncation will be an important issue for SaaS purchases. Is the object of the transaction the purchase of software (like a spreadsheet program, for example) or a non-taxable service or intangible?

How Are Prewritten Computer Software Access Services Sourced?

When the sales tax was expanded in 2018-2019, the services subjected to tax were generally such that the service was received in the same location as where the service was performed, e.g., landscape services. But, prewritten computer software access services may be received in many locations. Surely, the General Assembly did not intend for the Kentucky sales tax to extend to the receipt of such services outside of Kentucky.

The Department has not addressed sourcing for prewritten computer software access services, but it has referred taxpayers to KRS 139.105 as applying to other services. According to the Department, "Sales tax on services is based on where the customer receives the service. For example, a lobbying provider located in Washington, D.C. lobbying on behalf of a Kentucky client would charge the Kentucky sales and use tax because the client is receiving or making first use of the service in Kentucky. See guidance on the sourcing of retail sales in KRS 139.105 and information on receiving services in Kentucky Administrative Regulation

103 KAR 30:190." Ky. Dep't of Revenue, Tax Answers (Dec. 2022) (Lobbying Services). Extrapolating this to prewritten computer software access services, logically, a position could logically be developed that Kentucky sales tax applies only to prewritten computer software access services received in Kentucky.

Taxpayers based in Kentucky purchasing prewritten computer software access services that will be received in locations outside of Kentucky should consider informing the seller of the locations to which service will be received; otherwise, the seller could inadvertently bill Kentucky sales tax on services delivered outside of Kentucky as under KRS 139.105, the sales tax is generally sourced to the address of the purchaser when the locations to which service will be received are unknown. In such a situation, this statutory presumption would seem to be constitutionally suspect due to extraterritorial effect.

What About Exemptions?

As the scope of services subject to sales and use tax expands, the importance of exemptions increases. Fortunately, prewritten computer software access services may be purchased tax-exempt as for resale. The Department recognized this in Kentucky Sales Tax Facts (June 2022), stating, "KRS 139.260 is amended [by H.B. 8] to allow all the newly taxable services (KRS 139.200(2)(g) through (ay) to be purchased for resale."

Software delivery has evolved from being delivered to computers via tangible mediums like disks and CDs to downloads, and now to SaaS.

Unquestionably, many exemptions apply to prewritten computer software that is delivered via tangible mediums or downloaded, but what about prewritten computer software access services?

The imposition of Kentucky sales tax on prewritten computer software access services will create some issues, but some thoughtful planning can hopefully address many of them.

This is a modified version of Mark A. Loyd's regular column, Tax in the Bluegrass, "What to Do Now that Kentucky taxes SaaS" which appeared in Issue 1, 2023 of the Kentucky CPA Journal.

KDOR issues Software as a Service Guidance (effective until January 1, 2023)

Cloud-based computing has increasingly become the go-to for individuals and businesses looking to securely store their data, files, photos, and more. Given the ever-evolving nature of this technology, questions often arise as to how the sales and use tax applies to transactions related to cloud-based software and ancillary services. In Private Letter Ruling KY-PLR-21-01 ("PLR"), the Kentucky Department of Revenue ("KDOR") recently determined that an application provided as part of a Software as a Service model, also known as SaaS, was not subject to Kentucky sales tax.

The taxpayer requesting the ruling provides web-based service via a SaaS model, which involves its customers accessing prewritten computer software hosted online with no physical download or transfer. In the PLR, the Department confirms that such transactions are not subject to Kentucky sales and use tax because there is no transfer or sale of tangible personal property. This is in contrast to the purchase of prewritten computer software via physical copy, for example, on a CD or thumb drive, which involves the transfer of tangible personal property and which is thus taxable.

The taxpayer requested guidance regarding a subsequent free offer of a downloadable prewritten computer software application which enhanced the primary software's usefulness, but which ultimately provides limited functionality. Specifically, the taxpayer requested a ruling as to whether this download would change the original exempt nature of the taxpayer's SaaS product.

KDOR found that offering the prewritten computer software application as part of the taxpayer's SaaS did not create a transaction subject to Kentucky sales and use tax. KDOR specified that the SaaS remained available online and that the application did not transform the transaction into one involving tangible personal property. KDOR also found that providing the application along with the SaaS did not create a bundled transaction because the free software application was a de *minimis* part of the product the taxpayer provided to customers.

Because this guidance was issued in a private letter ruling, it is binding only to the specific taxpayer for which the ruling was issued. However, it may be instructive for similarly-situated taxpayers. It also illustrates the potential pitfalls to which such taxpayers may be exposed if they provide exempt SaaS products but offer additional ancillary products.

Notably, HB 8 extends the sales tax to prewritten computer software access services, effective January 1, 2023.

Kentucky Governor Provides Property Tax Relief

Kentucky Governor Andy Beshear issued an executive order on February 16, 2022 intended to stop an increase in vehicle property taxes for 2022. Used car values in Kentucky have risen approximately 40% since last year, from $8,006 to $11,162. Under Governor Beshear's order, taxpayers will pay a similar amount of tax to what they paid in 2021, assuming they own the same vehicle in the same condition and in the same county. The relief will continue through the next two years. If a taxpayer has already paid their 2022 property tax on their vehicle, they will receive a refund from their county clerk.

Kentucky law generally requires the General Assembly to exempt all or part of the personal property tax applied to vehicles. The Senate issued Senate Joint Resolution 99 (R.S. 2022) earlier this year that stated that the Governor could also provide vehicle property tax relief. Following that joint resolution, Governor Beshear issued his executive order.

Subsequently, on March 10, 2022, Governor Beshear signed related legislation into law. The law exempts from the January 1 assessment dates for 2022 and 2023, the portion of taxes computed on any increase in a motor vehicle's valuation from January 1, 2021. It also entitles taxpayers who paid the tax on any increase in their vehicle's valuation from 2021 to a refund of the tax overpayment. The law further requires the Department of Revenue and county clerks to establish procedures to enable taxpayers to receive refunds without making a written request and requires the refunds to be issued within 90 days of the effective date. The law took effect March 10, 2022.

KDOR Announces Decrease in Property Tax Rate

On July 1, 2022, the Kentucky Department of Revenue announced it would be setting the 2022 real property tax rate at 11.5 cents per $100 of assessed value, a decrease from the 2021 rate of 11.9 cents per $100. The reduction of rate is the result of 7.36% estimated increase in revenue from real property assessments from 2021 to 2022; because the estimated increase in revenue is more than 4%, the 2021 rate must be reduced.

No Kentucky Tax Amnesty in 2023

House Bill 8 (HB 8) revised the Kentucky Tax Amnesty Act and established a tax amnesty program for 2023 in the event the Kentucky Department of Revenue (KDOR) could not implement one in 2022. However, with two and a half weeks remaining before the statutorily-mandated tax amnesty program is to begin, legislative critics have argued that KDOR has yet to make preparations for the tax amnesty program and ignored HB 8's directive. The legislative critics note that KDOR could have contracted out the administration of the tax amnesty program and argue that KDOR's failure to either contract out or implement the tax amnesty program itself is a major oversight by KDOR.

In response, Governor Beshear's team argues the oversight is due to the legislature's failure to heed Beshear's warning and provide KDOR with the required funding to implement or oversee the tax amnesty program. When Governor Beshear vetoed HB 8 in April 2022, he warned the legislature of KDOR's lack of resources and called the tax amnesty program "another unfunded mandate." In a letter dated June 8, 2022, Beshear reiterated KDOR's lack of resources required to fund the tax amnesty program when he stated that KDOR would request a proposal, but would have to provide a disclaimer that KDOR could not pay the vendor. Beshear also offered another warning that KDOR needed funding to implement the 2023 tax amnesty program.

This back-and-forth between the executive branch and legislative branch has led to taxpayer confusion regarding whether and when tax amnesty may be available. Taxpayers should consider options for resolving amounts that may be eligible for amnesty.

III. Trends to Watch

A. Nexus and Telecommuting

The COVID-19 pandemic has thrown an already-exiting trend into sharper relief: where a business's employees work. For employers employing Kentucky residents and/or nonresidents who reside in states with which Kentucky has a reciprocal agreement, they will not need to change their current withholding practices during the period when these employees are working from home. Requirements for withholding of tax in either case remain unchanged by restrictions related to the COVID-19 pandemic and resulting emergency procedures. KDOR will continue reviewing Kentucky income tax nexus determinations on a case-by-case basis, though companies should continue to keep in mind federal Public Law 86-272, which prohibits states from imposing income tax on a business's income derived from interstate commerce if the business has only limited business activity in the state.

B. Expansion of Sales Taxes to Services

Kentucky has joined a growing number of states seeking additional tax revenue by expanding its sales tax base to services. Kentucky has reduced its individual income tax in recent years, and has sought to fill the gap in revenue by looking to services on which it can levy its sales tax. Kentucky greatly expanded the number of services subject to sales tax effective January 1, 2023, and if those efforts prove fruitful, the list of taxable services may continue to expand in future years.

C. Property Tax Assessment Reduction Opportunities

As interest rates have greatly risen over the last year and both residential and commercial real estate values have declined relative to their upward of the last several years, there may be opportunities for certain property owners to seek a reduction in their property tax assessments. Property owners may wish to review recent sales of comparable properties to see if their current assessment is in line with the market. Commercial real estate owners should review their cap rate and income stream, particularly if their operating expenses have grown, their property remains vacant (for example, in office buildings whose tenants have not returned after COVID-19), or their income stream has otherwise been affected by the economy. Kentucky property tax season begins in May, so property owners should begin reviewing their assessments now.

IV. Select Case Updates

***Dep't of Rev., Fin. and Admin. Cabinet v. Carriage Ford, Inc.*, No. 2022-CA-0231-MR (Ky. App. July 14, 2023), petition for rehearing denied (August 29, 2023), *aff'g* No. 19-CI-00655 (Franklin Cir. Ct. January 25, 2022) (opinion not yet final)– Motor Vehicle Usage Tax Refund**

Carriage Ford (Taxpayer) is an Indiana car dealership that sells cars to Kentucky residents. Taxpayer paid Kentucky's motor vehicle usage tax for Kentucky customers. In 2015, the Indiana Department of Revenue audited Taxpayer and found Taxpayer owed Indiana sales tax for cars sold to Kentucky residents who took possession in Indiana. Taxpayer paid the Indiana taxes and requested a refund from KDOR. The Court of Appeals affirmed the Franklin Circuit Court which remanded the case to the now KBTA with direction that the requested refund of tax and interest be granted to Carriage Ford pursuant to KRS 134.580.

The authors' law firm represents Carriage Ford in this action.

Dunn v. Solomon Found., Nos. 2022-CA-0399-MR and 2022-CA-0401-MR (Ky. App. Apr. 28, 2023), _affirming_, No. 21-CI-00191 (McCracken Cir. Ct. Oct. 12, 2021) –Religious Exemption

The authors' law firm represents The Solomon Foundation in this action.

Dep't of Rev., Fin. and Admin. Cabinet v. Marathon Pipe Line, LLC, No. 2021-CA-0626-MR (Ky. App. May 13, 2022), _discretionary review denied_, 2022-SC-0233 (Ky. Oct. 12, 2022) – Tangible Personal Property Tax

Marathon Pipe Line, LLC (Marathon) is a public service corporation (PSC) that owns or leases thousands of miles of pipeline throughout the United States, including a 265-mile long tract from Owensboro to a Catlettsburg refinery located in an activated Foreign Trade Zone (FTZ).

At issue in this case is whether the pipeline was real property or tangible personal property; tangible personal property located in an FTZ is taxed at a very favorable rate. The Department of Revenue, Finance and Administration Cabinet, Commonwealth of Kentucky (the Department) assessed the pipeline as real property, at $242 million in 2014, $225 million in 2015, and $240 million in 2016. Marathon protested and asserted the pipeline was taxable as tangible personal property with values of $120 million, $106 million, and $106 million respectively. Marathon appealed to the Kentucky Claims Commission, now the Kentucky Board of Tax Appeals (KBTA/KCC). KBTA/KCC bifurcated the appeal and concluded that the pipeline is tangible personal. The Franklin Circuit Court affirmed KBTA/KCC's finding that Marathon's pipeline is tangible personal property. The Department appealed to the Court of Appeals.

Because it was an appeal from an administrative agency, the Kentucky Court of Appeals reviewed the case under the clearly erroneous standard. The Department cites Cumberland Pipe Line Co. v. Lewis, 17 F.2d 167 (E.D. Ky. 1926), which held that a similar pipeline was real property, and 103 KAR 8:090 which states that a transmission pipeline is real property. However, the Court of Appeals agreed with KBTA/KCC and the circuit court, on the rationale that the pipeline was: not annexed to the realty as it is moveable; not adapted to the use or purpose of the land above it; and intended by the parties to be moved and not a permanent accession to the land.

Furthermore, the Court of Appeals found that the Department's treatment of pipelines was not uniform, evidenced by its classification of MarkWest Energy's pipeline as tangible personal property. The court also noted that 103 KAR 8:090 indicates that a transmission line should be classified as real property, but another type of pipeline used to transport crude oil (a gathering line) should be classified as personal property. As for the ad valorem tax, the court found no error in KBTA/KCC's adoption of Marathon's numbers as the final order specified how KBTA/KCC found Marathon's expert testimony more persuasive than the Department's.

Century Aluminum of Ky. v. Dep't of Revenue, No. 19-CI-00424 (Franklin Cir. Ct. Feb. 3, 2020), _affirmed_ 2020-CA-0301-MR (Ky. App. July 9, 2021), _reversed and remanded_, 2021-SC-0300 (Ky. December 15, 2022), _petition for rehearing denied_ (Mar. 23, 2023) – Sales Tax – Manufacturing Supplies Exemption

The Kentucky Supreme Court held that certain items purchased by Century Aluminum and consumed in its manufacturing process were tax-exempt supplies, not taxable repair, replacement or spare parts. Century Aluminum of Kentucky, GP v. Department of Revenue, 2021-SC-0300-DG (Ky. December 15, 2022) (designated to be published). In holding for the taxpayer, the Court reversed the Court of Appeals' opinion affirming the Franklin Circuit Court and remanded the case to the Kentucky Claims Commission ("KCC"), now the Board of Tax Appeals, for reinstatement of its Final Order. Century is an aluminum manufacturer in Hawesville, Hancock County, Kentucky.

From November 2010 to May 2015, as part of its aluminum manufacturing business, "Century purchased anode stubs, Inductotherm lining, thermocouples and tube assemblies, and welding wire and industrial gases from Kentucky vendors in the relevant time period." Id. at 2. Although vendors initially collected sales tax from Century on the items and remitted the tax to the Department, Century subsequently concluded these items were properly characterized as tax-exempt supplies, not taxable repair, replacement or spare parts, and filed refund requests for these purchases. Id. The Department denied the refund requests and issued a Final Ruling Letter for each vendor, which Century (as assignee of the vendors rights in the refund requests) appealed to the KCC. Id. at 2-3. At the KCC, Century argued that each item was necessary to the manufacturing process and had a limited useful life. The Department argued that if items which meet the qualification of a tax-exempt supply also meet the definition of a taxable part, then they will be held taxable. Id. at 2-6. Both parties produced witnesses to support their claims. Id. at 3.

The KCC determined that the anode stubs, Inductotherm lining, thermocouples and tube assemblies, and welding wire and industrial gases used for welding are tax-exempt supplies under KRS 139.470(10)(a)2.b. Id. at 6-7. The KCC rejected the Department's interpretation, which would allow most tangible personal property meeting the criteria for a tax-exempt supply to be also categorized as a taxable part, and concluded that the test for final categorization is whether the item is intended to be used up in the manufacturing process or simply wears out. Id. at 6. Under this test, the KCC determined that the items at issue would be categorized as tax-exempt. Id. at 7. The Department appealed.

On appeal, the Franklin County Circuit Court reversed the KCC, and was affirmed by the Kentucky Court of Appeals. The circuit court agreed with the Department finding the items were introduced to maintain, restore, mend, or repair machinery or equipment used at Century's facility, and were therefore taxable under KRS 139.470(10). Id. at 9-10. The Court of Appeals, , like the circuit court, and were therefore

Who taxable under KRS 139.470(10). Id. at 9-10. The Court of Appeals, like the circuit court, concluded that KRS 139.470(10) and KRS 139.010(26) are not in conflict and do not need to be harmonized, making Century's proposed test unnecessary. Id. at 10-11. In addition to the two parties' merit briefs, amici curiae Kentucky Association of Manufacturers and Kentucky Chamber of Commerce filed briefs with the Kentucky Supreme Court as well.

The Court acknowledged that "[c]ategorization of an item as a supply is…at the heart of this dispute." Id. at 15. In reversing the Court of Appeals, the Kentucky Supreme Court agreed with the KCC's "ultimate conclusion that a distinguishing difference between a tax-exempt supply and a taxable part is whether the tangible personal property is consumed in the manufacturing process and has a useful life less than one year," [*id.* at 12-13], noting that its decision was "based upon the plain language of the statutes." *Id*. at 12. The Court explained that in order to be categorized as a supply, an item must be (i) tangible personal property that is (ii) consumed when used in the manufacturing or industrial processing and is directly used in such processing, and (iii) having a useful life of less than one year. *Id*. at 15-16 (citing KRS 139.470(10)). The Court explained that, "upon consideration of the statutory language as a whole, that plain language incorporates the principles expressed in Mansbach and Century Indemnity." *Id*. at 20 (citing *Mansbach Metal Co. v. Dep't of Revenue*, 521 S.W.2d 85, 87 (Ky. 1975), and *Century Indemnity Co. of Chicago, Ill. v. Shunk Mfg. Co*., 68 S.W.2d 772, 774 (Ky. 1934). Among these principles, the Court included one that was referenced in the Amici Curiae Brief filed by the Kentucky Association of Manufacturers and joined by the Kentucky Chamber of Commerce, that "a distinction could be drawn between materials and supplies and parts, that distinction being that materials and supplies are designed and intended to be used up in the manufacturing process and parts simply wear out." Century Aluminum, supra, at 18, (citing *Mansbach*, 521 S.W.2d at 86-87) (emphasis added); see also Amici Curiae Brief, at 10, n.5. The Court therefore agreed with the KCC's ultimate finding that the items were categorized as tax exempt because all items at issue were tangible personal property that had direct use in manufacturing in a manufacturing facility and had a useful life of less than one year.

This decision impacts all Kentucky manufacturers. As explained in the Amici Curiae Brief, manufacturing is undisputedly the "economic engine" of Kentucky, accounting for 17.8% of the total output in the state and employing 13.29% of the workforce; the total output from manufacturing in Kentucky was $38.33 billion in 2019. Amici Curiae Brief, supra, at 1. Every manufacturer with a plant in Kentucky purchases supplies used in their manufacturing operations to which the manufacturing supplies exemption of KRS 139.470(9)(b)2.b may apply to exempt such supplies for sales and use tax purposes. Accordingly, this particular exemption is of widespread application and importance to many Kentucky taxpayers. Now, those taxpayers have clarity on the supply exemption's scope.

In June of 2023, KDOR issued guidance in response to the decision, stating that tangible personal property that qualifies as an exempt supply but for the "repair, replacement, or spare part" exclusion will qualify as an exempt supply. If all other criteria for the exemption are met, the items consumed in the manufacturing process are exempt even if performing a maintenance function. Based on this expanded interpretation of the exemption, the KDOR will continue to make determinations on a case-by-case basis.

The authors' law firm represents *amici* in this action.

***Louisville/Jefferson County Metro Revenue Commission v. Ventas, Inc.,* No. 19-CI-000899 (Jefferson Cir. Ct. Feb. 8, 2021), *affirmed,* No. 2021-CA-0235-MR (Ky. App. Feb. 11, 2022) – Occupational License Tax/Sovereign Immunity**

Ventas, Inc. ("Ventas") is a national healthcare real estate investment trust ("REIT") that transacts business in multiple jurisdictions, but is headquartered in Louisville, Kentucky. In 2019, Ventas filed a declaration of rights action seeking an order that it is entitled a variance from the standard apportionment formula used by Metro Revenue in calculating occupational license tax. Metro Revenue moved to dismiss the case on the grounds of sovereign immunity, mootness, and ripeness. The Jefferson Circuit Court denied the motion, and Metro Revenue appealed the sovereign immunity issue alone to the Kentucky Court of Appeals.

The Court of Appeals affirmed the Circuit Court, holding that the Revenue Commission was not entitled to sovereign immunity in a declaratory judgment action: "…the Revenue Commission [contends] that a refund claim is implicit in the declaratory judgment action filed by Ventas and that a refund 'presents a harm to state or government resources that implicates sovereign immunity.' However, the only claim presented in the complaint filed by Ventas is one for declaratory judgment….it simply asked the circuit court to decide whether it was entitled to relief in the form of an alternative and equitable apportionment. Consequently, the declaratory judgment action did not impinge upon the Revenue Commission's governmental immunity."

The original declaratory judgment complaint (which has since been amended) is proceeding at the Circuit Court.

The authors' law firm represents the taxpayer in this action.

***LWAGLVKY 1, LLC, et al. c/o Walgreen Co. v. Jefferson Co. PVA, et al.,* No. K19-S-88, 207-210 (Ky. Bd. Tax App. Aug. 25, 2021), on appeal, 21-CI-005434 (Jefferson Cir. Co. Sept. 24, 2021) – Property Tax**

The KBTA issued its Final Order in *LWAGLVKY 1, LLC, et al. c/o Walgreen Co. v. Jefferson County PVA*, No. K19-S-88, 207-210 (Ky. Bd. Tax App. Aug. 25, 2021) concerning the assessment value of 15 properties leased by Walgreens throughout the Louisville Metro Area. Walgreens obtained fee simple appraisals for each property, using local market conditions and market rent, and argued that the fee simple appraisals represented the fair cash values for the properties

Who taxable under KRS 139.470(10). Id. at 9-10. The Court of Appeals, like the circuit court, concluded that KRS 139.470(10) and KRS 139.010(26) are not in conflict and do not need to be harmonized, making Century's proposed test unnecessary. Id. at 10-11. In addition to the two parties' merit briefs, amici curiae Kentucky Association of Manufacturers and Kentucky Chamber of Commerce filed briefs with the Kentucky Supreme Court as well.

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The authors' law firm represents *amici* in this action.

***Louisville/Jefferson County Metro Revenue Commission v. Ventas, Inc.,* No. 19-CI-000899 (Jefferson Cir. Ct. Feb. 8, 2021), *affirmed,* No. 2021-CA-0235-MR (Ky. App. Feb. 11, 2022) – Occupational License Tax/Sovereign Immunity**

Ventas, Inc. ("Ventas") is a national healthcare real estate investment trust ("REIT") that transacts business in multiple jurisdictions, but is headquartered in Louisville, Kentucky. In 2019, Ventas filed a declaration of rights action seeking an order that it is entitled a variance from the standard apportionment formula used by Metro Revenue in calculating occupational license tax. Metro Revenue moved to dismiss the case on the grounds of sovereign immunity, mootness, and ripeness. The Jefferson Circuit Court denied the motion, and Metro Revenue appealed the sovereign immunity issue alone to the Kentucky Court of Appeals.

The Court of Appeals affirmed the Circuit Court, holding that the Revenue Commission was not entitled to sovereign immunity in a declaratory judgment action: "…the Revenue Commission [contends] that a refund claim is implicit in the declaratory judgment action filed by Ventas and that a refund 'presents a harm to state or government resources that implicates sovereign immunity.' However, the only claim presented in the complaint filed by Ventas is one for declaratory judgment….it simply asked the circuit court to decide whether it was entitled to relief in the form of an alternative and equitable apportionment. Consequently, the declaratory judgment action did not impinge upon the Revenue Commission's governmental immunity."

The original declaratory judgment complaint (which has since been amended) is proceeding at the Circuit Court.

The authors' law firm represents the taxpayer in this action.

***LWAGLVKY 1, LLC, et al. c/o Walgreen Co. v. Jefferson Co. PVA, et al.,* No. K19-S-88, 207-210 (Ky. Bd. Tax App. Aug. 25, 2021), on appeal, 21-CI-005434 (Jefferson Cir. Co. Sept. 24, 2021) – Property Tax**

The KBTA issued its Final Order in *LWAGLVKY 1, LLC, et al. c/o Walgreen Co. v. Jefferson County PVA*, No. K19-S-88, 207-210 (Ky. Bd. Tax App. Aug. 25, 2021) concerning the assessment value of 15 properties leased by Walgreens throughout the Louisville Metro Area. Walgreens obtained fee simple appraisals for each property, using local market conditions and market rent, and argued that the fee simple appraisals represented the fair cash values for the properties under Kentucky law. PVA put forth evidence of a leased fee valuation for each property, using above-market contract rent and national sales, arguing that the value of the leased fee represented the properties' fair cash value for ad valorem tax purposes. The KBTA held that, through its presentation of evidence, Walgreens overcame the presumption in favor of the PVA's valuation. The KBTA found in favor of Walgreens for the two Walgreens-owned properties, but sided with the PVA on the 13 properties with leases. The KBTA made no findings concerning Walgreens' constitutional claims that the PVA's assessments violate uniformity and equal protection when PVA's assessments were double or more than those of comparable retail properties in the county. Walgreens appealed the KBTA's order concerning the 13 leased properties and the constitutional claims to Jefferson Circuit Court, where the case has been briefed and is awaiting review.

The authors' law firm represents the taxpayer in this action.

***Foresight Coal Sales, LLC v. Chandler*, 60 F.4th 288 (6th Cir. 2023), petition for writ of certiorari filed, U.S. Supreme Court Docket No. 22-1083 (May 4, 2023). – Coal Severance Tax/Commerce Clause**

In *Foresight Coal Sales, LLC v. Chandler*, the Sixth Circuit Court of Appeals held that Kentucky Senate Bill 257 ("SB 257") unconstitutionally favors in-state coal over out-of-state coal, in violation of the dormant Commerce Clause SB 257 directs the Public Service Commission ("PSC"), a Kentucky agency, to evaluate the cost of coal after subtracting any severance tax paid. Because not every state imposes a severance tax, the court found that the deduction of any severance tax paid from the PSC's calculation discriminated against interstate commerce to make Kentucky coal more affordable, to the detriment of out-of-state coal companies.

The PSC is tasked with ensuring that energy rates are "reasonable" for consumers by conducting semi-annual and biennial reviews of each utility to check, among other things, the price paid for raw materials. Since the price of coal is a factor used by the PSC in the review that determines whether the utility may pass on its costs to customers, the 4.5% severance tax on Kentucky coal producers makes utilities less likely to buy Kentucky coal. In an effort to level the playing field, in 2021, Kentucky's governor signed SB 257, which required the PSC to evaluate the "reasonableness of fuel costs" after subtracting "any coal severance tax imposed by any jurisdiction."

Foresight Coal Sales, LLC ("Foresight") sued the PSC and sought a preliminary injunction to block SB 257's implementation. The United States District Court for the Eastern District of Kentucky denied the preliminary injunction and Foresight appealed. When considering a preliminary injunction, the court must balance several factors: (1) whether the movant is likely to succeed on the merits; (2) whether the movant would suffer an irreparable injury if relief were not granted; (3) whether the injunction would cause substantial harm to others; and (4) whether the injunction would serve the public's interest.

The Commerce Clause provides Congress both an affirmative power to regulate interstate commerce and a negative (dormant) power to prevent "economic Balkanization." This dormant Commerce Clause prevents state regulations from discriminating against or imposing an "undue burden" on interstate commerce.

The Sixth Circuit reasoned that because only the state from which the coal was extracted from may impose a severance tax, the tax is a proxy for the coal's state of origin. SB 257 not only requires coal from severance-taxing states and non-severance taxing states to be treated differently, but SB 257 also differentiates treatment between severance-taxing states based on the amount of tax. Although the PSC argued that SB 257 could treat coal from the same state differently, the court found the line between explicitly discriminating against out-of-state goods and "in effect" discriminating irrelevant. Moreover, the court found it unnecessary to determine the extent of the burden placed on out-of-state coal because the dormant commerce clause looks at whether there is "any economic disadvantage" imposed on the out-of-state coal.

Here, coal from non-severance taxing states do not get any discount, causing the out-of-state coal to be more expensive, which would lead to either a loss in market share or mandatory lowering of prices in an effort to compensate. Meanwhile, coal from severance-taxing states—such as Kentucky—will receive a discount. The PSC's offered purpose for SB 257, to "even out the playing field," is itself discriminatory and violates the principles found in the Supreme Court of the United States' ("SCOTUS") dormant Commerce Clause jurisprudence. SCOTUS' three principles are: (1) even a retaliatory discriminatory policy is a violation of the commerce clause, (2) the benefits to an out-of-state interest does not justify the burdens, and (3) if the policy requires another state enacting the same policy, then the policy is discriminatory.

Furthermore, the Sixth Circuit distinguished *Henneford v. Silas Mason Co.*, which held that a 2% use tax on out-of-state goods was the same as the 2 % sales tax on in-state goods, therefore it did not violate the commerce clause. However, *Silas* is the narrow exception to the aforementioned principles because it is sufficiently justified. Moreover, even if *Silas* was applicable, SB 257 would still fail since SB 257 is not a tax, nor would it meet the compensatory tax criteria: (1) the state identified a burden the state wants to compensate, (2) the state demonstrated its equal treatment of interstate commerce, and (3) the state showed that the taxes achieve the same purpose.

Lastly, contrary to the PSC's argument, Hunt v. Washington State Apple Advertising Comm'n did not hold that "unearned" advantages could be taken away; therefore, although out-of-state coal did not "earn" its pre-SB 257 advantages, it does not follow that Kentucky may take those advantages away with SB 257's discounting. Finding that Foresight was likely to succeed on the merits, the Court remanded the case to the lower court to analyze the remaining three preliminary injunction factors.

The PSC filed a writ of certiorari with the United States Supreme Court on May 4, 2023, and the Court ordered briefing on the petition. The case has been submitted for the conference of September 26, 2023. The Court declined review of *Foresight*, SCOTUS demonstrating that perhaps it does not intend to limit the dormant Commerce Clause's scope, leading to state laws concerning interstate commerce risking future *Foresight*-esque litigation.

***Lowe's Home Centers, Inc. v. Jefferson Co. PVA,* File Nos. K20-S-168, -169, & 170 (KBTA, June 6, 2022), *on appeal,* No. 22-CI-005657 (Oct. 28, 2022, Jefferson Cir. Ct.) & *Lowe's Home Centers, Inc. v. Montgomery Co. PVA,* File No. K20-S-036 (KBTA, April 27, 2022), *on appeal,* No. 22-CI-90079 (June 3, 2022, Montgomery Cir. Ct) - Property Tax**

These two cases involve 2020 real property tax appeals brought by Lowe's Home Centers, Inc. ("Lowe's") for big box stores owned in fee simple and occupied by the taxpayer. In each instance, the KBTA held for the PVA, and Lowe's has appealed.

In each case, Lowe's relied on the same MAI-designated expert witness who appraised the involved properties and testified as to her appraisal report. The PVA in Jefferson County relied on its Director of Research and Valuation, who was also called as an expert witness. The PVA in Montgomery County called three witnesses: the PVA, a Department of Revenue employee who was qualified as an expert witness, and an MAI-certified appraiser, who was also qualified as an expert witness.

In both counties, for each property, the Lowe's appraiser used the sales and income approaches to valuation. She did not use the cost approach given the age of the properties. For the sales approach, the Lowe's appraiser relied on four fee-simple sales, all of which were vacant at the time of the sale, and three leased-fee sales that had ongoing operations in the property. Each sale was then adjusted to account for differences between them and the subject properties. For the income approach, the Lowe's appraiser looked at actual recent leases from comparable retail spaces and asking rents for competitive properties. Each of those leases was then adjusted and a capitalization rate was developed. Finally, the Lowe's appraiser reconciled each value to arrive at the final indication of value for the properties.

The Jefferson County PVA's witness also performed a sales comparison and income approach. For the sales approach, the witness looked at four properties in Jefferson County, all of which were leased, and adjusted them. For the income approach, he relied on five comparables in Jefferson County, each of which was leased, and adjusted them. The PVA asserted that KBTA should increase the valuations of the subject properties above the PVA's original assessment.

The Montgomery County PVA's witnesses testified as to the PVA's value. The PVA himself testified that the property was valued based on the cost approach in 2008, shortly after it was built, and continued to be assessed at that rate through 2020. The Department of Revenue employee performed a current cost approach, which included the building's replacement cost, but not land value. He also testified that vacant properties are not comparable to occupied properties for valuation purposes. The PVA's expert appraisal witness testified as to the sales and income approaches, and used a hypothetical condition for the subject property, namely that he assumed the property was leased at prevailing market rates. For the sales approach, he used six properties occupied by a Lowe's store at the time of sale and sold on a leased-fee basis. For the income approach, he chose seven comparables (three Lowe's stores, and four other stores). He then estimated market rent and developed a capitalization rate. Finally, the appraiser reconciled the approaches to arrive at a final valuation.

In both cases, the KBTA determined that Lowe's' evidence failed to rebut the presumption in favor of the PVA's assessment value and that even if it had introduced such evidence, the PVA's evidence was more persuasive. Though the reasoning differed slightly in each case given the facts involved, the KBTA ultimately determined that the Lowe's appraiser's use of vacant properties did not support reducing the PVA's assessment value. In essence, the KBTA determined that the Lowe's appraiser did not use comparable properties to develop her valuation. The KBTA also pointed out that in each case, it found the PVA witnesses' comparable properties to be "superior." It thus held for the PVA in each case.

Notably, in the Jefferson County case, the PVA had tried to argue that the Board should increase the valuation from the original PVA value as upheld by the county Board of Assessment Appeals ("BAA"). The KBTA determined that it could not raise a value as upheld by the BAA because its jurisdiction is limited to trying anew the issues as they were presented to the BAA. Because the PVA had not asserted the higher valuation to the BAA, the KBTA could not order a higher value.

As noted, Lowe's has appealed both cases, and each appeal is currently pending with the county circuit court.

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