

Kentucky Tax Developments: Spring 2022

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I. 2022 LEGISLATIVE UPDATE

There are several notable tax developments from the Kentucky 2022 regular session, including House Bill 8 (“HB 8”). HB 8 includes a proposal to reduce the individual income tax and continues to expand the sales tax base by imposing sales tax on more than thirty new services. Rather than reducing the individual income tax outright, HB 8 would establish a rate reduction evaluation, with any potential tax rate reduction beginning on January 1, 2023. Services proposing to be taxed include cosmetic surgery services, marketing services, photography and photo-finishing services, prewritten computer software access services, telemarketing services, lobbying services, executive employee recruitment services, website design and development services, website hosting, certain repair services. HB 8 as proposed includes specific statutory definitions for only some of the additional services. Also included in HB 8 is a proposed tax amnesty program, available to all taxpayers from October 1 through November 29, 2022. HB 8 has passed both the House and the Senate and is now before the Governor.

Many are also closely watching House Bill 260 (“HB 260”), which could have significant impact on property tax assessments in Kentucky, likely resulting in an increase in property taxes for small and large businesses alike. As introduced, HB 260 proposed expanding the requirements of the income approach for property valuation to include the value of long-term leases, including triple net leases; though these proposed

modifications have since been removed from the bill. In its current form, HB 260 would mandate market segmentation of properties, amending the sales comparison approach for property valuation by requiring sales or rentals that look the same or similar and operate similarly to be considered comparable properties and prohibiting the use of vacant properties in comparable sales. Additionally, HB 260 establishes new requirements for the appraisal of real property, a dramatic shift from the current system, and limits tax representation to Kentucky licensed attorneys, CPAs, or real estate brokers. As of April 2, the bill has passed the House and is awaiting vote in the Senate prior to the close of the legislative session in mid-April.

II. EXECUTIVE & ADMINISTRATIVE UPDATES

KDOR ISSUES SOFTWARE AS A SERVICE GUIDANCE

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.

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.

KENTUCKY TAX REGULATIONS

Electronic filing is here to stay. Regulation 103 KAR 1:160, Mandatory Electronic Filing And Payment Requirements, is a new tax regulation concerning electronic filing and electronic payment of income, sales and excise taxes implemented pursuant to KRS 131.250 and KRS 131.155 which also addresses penalties for noncompliance, and provides for waivers of electronic filing requirements.

Regulation 103 KAR 16:270, Apportionment; Receipts Factor, was amended to address, among other things, the receipts factor in the context of financial institutions, which are subject to the corporate income tax, effective for tax years beginning on or after January 1, 2021.

As related by the Department in Kentucky Sales Tax Facts (May 2018), labor and installation charges are included in the definition of "gross receipts" subject to Kentucky sales tax and sales of extended warranty services covering tangible personal property that is taxable at retail to the warranty holder are subject to sales and use tax, as a result of 2018 HB 487, effective July 1, 2018. Regulation 103 KAR 27:150, Repairers

and Reconditioners of Tangible Personal Property, and Regulation 103 KAR 27:230, Motor Vehicle Body Shops, interprets the application of sales and use tax to repairers and body shops concerning, among other things, charges for installing or applying taxable repair parts and extended warranty services.

For manufacturers, it should be highlighted that Regulation 103 KAR 30:120, Machinery for New and Expanded Industry, was amended to address, among other things, exempt charges for labor or services to apply, install, repair, or maintain tangible personal property directly used in manufacturing or industrial processing. And, Regulation 103 KAR 30:140, Energy and Energy-Producing Fuels, implements amendments to KRS 139.480(3) in 2019 HB 354 which authorizes a manufacturer or industrial processor with tolling operations at a plant facility that meet certain criteria to exclude the cost of tangible personal property from the toller's cost of production in computing its sales tax exemption for energy costs exceeding 3% of its cost of production.

Regulation 103 KAR 26:131, Landscaping Services, is a new regulation that addresses the application of sales and use tax to landscaping services. These became subject to Kentucky sales and use tax, effective July 1, 2018 pursuant to 2018 HB 487.

Regulation 103 KAR 26:100, Industrial Laundry and Linen Supply Services, amends a longstanding regulation concerning the Department's interpretation of the application of sales and use tax to transactions involving industrial laundry and linen supply services; these services became subject to sales tax as a result of amendments effective July 1, 2018 to KRS 139.200(2) in HB 487. This Regulation merits a close read.

KRS 139.481, enacted effective January 1, 2021, requires farmers to apply for an Agriculture Exemption Number for use on exemption certificates that farmers must present to retailers when making sales tax exempt purchases. However, the amendments to Regulation 103 KAR 30:091, Sales to Farmers, do not appear to address KRS 139.481.

Curiously, for those who remember the Department's tax policies and revenue circulars, Regulation 103 KAR 16:352, Corporation Income Taxes Policies and Circulars, was amended to identify additional Revenue Policies and Revenue Circulars that have been rescinded.

III. KENTUCKY TAXES & COVID-19: CONTINUED CHANGES AND TRENDS TO WATCH

Like many states and the federal government, Kentucky continues to respond to the impact of the Coronavirus pandemic. In 2020, Kentucky extended tax filing and payment deadlines, paused collection activity, and provided other relief. In addition, many of KDOR's programs and services were altered or interrupted as a result of government office closures and health and safety mandates. While many of these services have now been restored and collections have resumed, following are updates concerning the continuing impact of Covid-19 on Kentucky tax law.

A. NEXUS AND TELECOMMUTING

The Covid-19 Pandemic brought about many changes, including 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. KENTUCKY ADOPTS FEDERAL TREATMENT OF PPP INCOME AND EXPENSES

In 2021 HB 278, the Kentucky General Assembly allowed for the same treatment of forgiven, covered PPP loans, deductions attributable to those loans, and tax attributes associated with the loans as allowed under P.L. No. 116-260, sec. 276 and 278. IRS Notice stated Loan Forgiveness Income Exempt and expenses deductible. Most notably, forgiven PPP loans not taxed and expenses paid with forgiven loans are deductible.

C. KDOR RESUMES COLLECTIONS

KDOR's Division of Collections resumed collection activity on June 11, 2021. Collection action was previously suspended due to the COVID-19 emergency. The Department encourages those who owe a balance to contact the Department. Taxpayers may see increased collection activity as COVID-19 backlogs are resolved on both state and federal levels.

All of KDOR's Coronavirus updates can be found at revenue.ky.gov/Pages/2019NovelCoronavirus.aspx.

IV. SELECT CASE UPDATES

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), discretionary review granted, 2021-SC-0300 (Ky. Feb. 16, 2022) – Sales Tax – Manufacturing Supplies Exemption

On February 16, 2022, the Kentucky Supreme Court granted discretionary review in *Century Aluminum of Ky. v. Dep't of Revenue* and will take up review of Kentucky's manufacturing supplies exemption. Briefing will begin in April 2022.

Below, the Court of Appeals upheld the decision of the circuit court in, holding that the circuit court properly interpreted the statutes and concluding that the certain items which were worn out during the manufacturing process and used "to maintain, restore, mend, or repair machinery or equipment" and, therefore, were taxable repair, replacement or spare parts.

The case concerned the manufacturing supplies exemption and was appealed from the Franklin Circuit Court, which reversed the Final Order of the Kentucky Claims Commission (now KBTA) ("KCC/KBTA") and found that the items were subject to Kentucky sales and use tax.

Century Aluminum argued that the items were not subject to Kentucky sales and use tax as tangible personal property for direct use in manufacturing or industrial processing and that the Department failed to distinguish between supplies and parts intended to be used up in the manufacturing process and supplies and parts which wear out and are subject to replacement. The KCC/KBTA held for Century Aluminum and adopted Century Aluminum's four-part test which compares the useful life of the item at issue when the machine or equipment it allegedly maintains is operating with and without the introduction of the product being manufactured. If there is a difference in the useful life of the item, then the item is being consumed in the manufacturing process; if not, then the item is a repair or replacement part.

The Department appealed the Final Order of the KCC/KBTA to the Franklin Circuit Court, which rejected this test, stating that it "ignores the fact that all tangible personal property used in the manufacturing process wears down or is used up" and that it would "exempt nearly all tangible personal property used in the manufacturing process from the sales and use tax, which is clearly not the intent [of the exemption]." Rather, the Court concluded that "the proper test is whether the items are introduced into the manufacturing process to maintain, restore, mend, or repair a machine or equipment, or whether the items...are used up or consumed as a consequence of their involvement in the manufacturing process."

The Court of Appeals agreed with the circuit court's rejection of Century Aluminum's proposed four-part test, finding that the Legislature intended for certain items in the manufacturing process to be tax-exempt and for other items, like the subject parts, to be taxable.

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)

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 action will proceed at the Circuit Court.

The authors’ law firm represent 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 represent the taxpayer in this action.

Kroger Ltd. P’ship I v. Scott Cnty. Prop’y Valuation Adm’r, et al, No. 2019-CA-01133-MR (Ky. App. July 17, 2020); remanded, Kroger Ltd. Partnership I v. Tim Jenkins, Scott Cty. Property Valuation Admr., K15-S-30 (Ky. Bd. Tax. App. May 28, 2021) – Property Tax

In a case involving the valuation of a big box grocery store, the Court of Appeals recently reversed the decision of the Scott County Circuit Court in *Kroger Ltd. P’ship I v. Scott Cnty. Prop’y Valuation Adm’r*, holding that “Based upon [the Court of Appeals] review of the properties relied upon by the PVA to determine comparable sales, we must agree with Kroger that the evidence it presented to counter the PVA’s assessment compels a finding that the Property was overvalued.”

The Property - which Kroger owns in fee simple - is located in Georgetown, Kentucky. It is 12.18 acres with a 130,600 square foot retail building of which just 1200 square feet, less than 1%, is leased to tenants other than Kroger, *i.e.*, 99% *non-leased*. Kroger owns and operates a Kroger grocery store on the property. As the Court explained, “For the tax year of 2015, the PVA assessed the value of the Property at \$15.2 million. Kroger sought review of the PVA’s assessment ...Kroger asserted that the Property’s fair cash value as of January 1, 2015, was \$6.6 million based upon an appraisal report from May 2014.” Kroger appealed to the BAA, which adjusted the PVA’s assessment slightly, to \$14.094 million. Kroger again appealed, and after a hearing at which an expert appraiser testified for Kroger, the KBTA and Scott Circuit Court each upheld the BAA’s valuation. Kroger appealed to the Court of Appeals, asserting that this valuation was not based on substantial evidence.

The Court of Appeals ultimately agreed with Kroger. As the Court explained, “Kroger’s expert relied upon both the comparable sales approach and the income approach to reach his opinion on the valuation of the Property at \$6.7 million.” The Court continued, “the properties the PVA relied upon were subject to leases, unlike the Property in this case. Kroger points out that a lease has its own value...and additional information is needed

to value properties with leases....Because the PVA did not introduce any evidence of this type to apply the necessary adjustments, Kroger argues that the valuation was erroneous.”

The Court went on to hold “Based upon our review of the properties relied upon by the PVA to determine comparable sales, we must agree with Kroger that the evidence it presented to counter the PVA’s assessment compels a finding that the Property was overvalued.” The Court explained that, “As [Kroger’s expert] testified before the Board, each of the property sales the PVA relied upon were not comparable to the Property in this case. They were subject to leases or were parts of other specific transactions, such as being part of a portfolio sale or a 1031 exchange, or were not a big box store. Therefore, these sales could not provide a basis for the PVA’s assessment, and the circuit court erred in affirming the Board’s final order.” The Court “also [agreed] with Kroger that the statement of value by Kroger’s consultant in 2013 cannot be substantial evidence of its fair cash value as of January 1, 2015, two years later.”

Accordingly, the Court reversed the Circuit Court and remanded the case, and the KBTA issued its order valuing the property at Kroger’s value of \$6.6 million on May 28, 2021.

The authors’ law firm represent the taxpayer in this action.

Agree Hazard KY, LLC dba Walmart v. Perry County Property Valuation Administrator & Perry County Board of Assessment Appeals, No. K17-S-163 (KCC May 22, 2019), on appeal, No. 19-CI-00285 (Perry Cir. Ct. June 21, 2019) – Property Tax

In *Agree Hazard KY, LLC dba Walmart v. Perry County Property Valuation Administrator & Perry County Board of Assessment Appeals*, No. K17-S-163, the KCC/KBTA reversed the Perry County Board of Assessment Appeals (“BAA”) and found that the subject property located in Hazard, Perry County, Kentucky, should be assessed using a value derived from the contract rent generated on the property and noted that such contract rent was a vital factor

and must be considered when assessing the property. Such a finding was a notable departure from the recommendations from the Hearing Officer, who had found the contract rent to be above-market and thus inapplicable.

Walmart's appraiser evaluated the fair cash value of the subject property (both leased fee and fee simple) using the sales comparison approach and the income approach. After appropriately adjusting and weighing both approaches, he determined that the 2017 value of the leased fee estate was \$23,225,000 and the 2018 value of the leased fee estate was \$22,500,000.

The PVA testified that the 2017 and 2018 assessments were entirely based on the consideration stated in the December 2015 deed. Moreover, the PVA admitted that they did not make any attempts to determine the fair cash value of the property and did not conduct any market research to determine changed market conditions from December 2015 to January of 2017 or 2018. Ultimately, the PVA's fundamental position was that the consideration stated in the December 2015 deed was an adequate justification of the assessment of the fair cash value of the property in 2017 and 2018. The Hearing Officer stated: "[T] his position implies that consideration, in all cases, is equivalent to the fair cash value. This is not the case. KRS 382.135 makes clear that "consideration" and "fair cash value" are not interchangeable terms." The Hearing Officer recommended that the property be valued at \$10,000,000 for 2017 and \$9,700,000 for 2018.

The KCC/KBTA adopted the majority of the recommendations set forth by the Hearing Officer, but diverted sharply on the final valuation of the subject property. In contrast to the Hearing Officer, the KCC/KBTA, stated, "the contract rent generated and realized on this property should not be disregarded when assessing this property." Furthermore, the KCC/KBTA also concluded that the fair cash value is best represented and derived using a leased fee valuation. The KCC/KBTA then reversed the BAA and ordered the retail building to be assessed at a fair cash value of \$23,225,000 for 2017 and \$22,500,000 for January 1, 2018.

The case is currently on appeal before the Perry County Circuit Court. On March 31, 2022, the case was dismissed for lack of prosecution, though a motion for reconsideration may still be filed.



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