COUNSEL'S CORNER

PROPERTY TAX

Kentucky Court Upholds Separate Taxation of Public Utility's Franchise at Full State and Local Property Tax Rates

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In a recent split decision, the Kentucky Court of Appeals held that the Department of Revenue ("Department") properly treated Dayton Power & Light Company's ("DPL") franchise as a separate and distinct class of property subject to public service company property tax ("PSC Tax") at full state and local tax rates, rather than allocating or "spreading" the franchise among the various classes of property, which would have taxed most of the franchise at lower state tax rates and exempted most of it from local taxation. *Dayton Power & Light Co. v. Dept. of Revenue,* No. 2011-CA-001438-MR, 2012 Ky. App. LEXIS 232 (Ky. App. Nov. 2, 2012), motion for discretionary review filed, (Ky., Dec. 3, 2012).

The Department argued that the franchise of a public service company must be taxed under a "catch-all" state rate and full local rates. *See, KRS 132.020(1)(r).* DPL argued that Kentucky law permitted it to pay tax rates on its franchise that were spread across a range of property asset classes, and that it was exempt, in some cases, from local taxation. *See, KRS 132.200.* DPL based this argument on Kentucky's requirement that "operating property and nonoperating tangible property shall be subject to state and local taxes at the same rate as the tangible property of other taxpayers not performing public services." *KRS 136.120(2(c).* DPL also argued that the doctrine of contemporaneous construction applied to bar the Department from changing its prior position of spreading the franchise among property classes.

As background, DPL is a public utility with no customers in Kentucky, but required to file PSC Tax returns with the Department since it owns a 31% interest in a power generating facility in Boone County, Kentucky. DPL identified five classes of property on its PSC Tax returns: (1) real estate, (2) tangible property, (3) manufacturing machinery, (4) pollution control equipment and (5) business inventory. The Department and DPL agreed that the unit value of DPL's operating property for the 2006 tax year was $110,621,241, and agreed that the value of DPL's franchise was $21,164,058.

Kentucky's PSC Tax Scheme

There is a provision in Kentucky's statutes for "other" tangible property that does not fall into any other category. Such property is subject to state tax at $0.45/$100 of value and is subject to local taxation. Further, business inventory is subject to state tax at $0.05/$100 and is subject to local taxation. *KRS 132.020(1)(n),(r);KRS 132.200.* Manufacturing machinery and pollution control equipment are subject to state tax at $0.15/$100 of value and are exempt from local taxation. *KRS 132.020(i),(k); KRS 132.200(4),(8).*

Under Kentucky's PSC Tax scheme, the operating property of a public service company consists of "both the operating tangible property and the franchise" and is assessed or valued as a unit. *See,* KRS § 136.115, *et seq.*

For purposes of the PSC Tax, the term "franchise" has been recently described as follows:

> [T]he earning value ascribed to the capital of a domestic public service corporation by reason of its operation as a domestic public service corporation. It comprises the operating property and is assessed by the Revenue Cabinet by its fair cash value as a unit. In this case, the franchise is the earning value ascribed to Comcast's capital by reason of its operation as a cable television provider. Said another way, the value of the franchise is determined by subtracting the assessed value of the tangible operating property from the "capital stock," which is the "entire property, real and personal, tangible and intangible, assets on hand, and its franchise as well."

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Revenue Cabinet v. Comcast Cablevision of the South, 147 S.W.3d 743, 752 (Ky. App. 2003) (*quoting Henderson Bridge Co. v. Commonwealth*, 99 Ky. 623, 31 S.W.486, 491 (Ky. 1895)).

Department's Change in Position

Prior to 2006, the DPL contends that the Department allowed DPL to spread the value of its franchise among the classes of property it owned, resulting in a lower tax rate and an exemption from local taxation for part of the value of its franchise. In 2006, the Department changed its position and issued PSC Tax assessments, taxing DPL's franchise as "other" tangible personal property at full state and local tax rates. This resulted in substantially higher taxes for DPL because the franchise was subject to a higher tax rate and its entire value was subject to local taxation. The Department contends, however, that it did not have a long-standing policy to spread the franchise among classes of property, but was simply "inconsistent" in its tax treatment of franchises. The Department contends that it should not be bound by an erroneous application of the law and that DPL should not be allowed to benefit from the Department's errors.

Board of Tax Appeals Finds Department's Position Violates Doctrine of Contemporaneous Construction.

DPL appealed the Department's assessments to the Kentucky Board of Tax Appeals ("Board"). The Board granted summary disposition for DPL, ruling the Department could not change its long-standing position without violating the doctrine of contemporaneous construction. The Board stated that "[t]he board is not inclined to overturn this precedent even though at a time of great budgetary stress the Appellee urges that after wandering in the darkness of incorrect and less remunerative interpretation they now 'have seen a great light', a new way of interpreting this statutory application." *Dayton Power and Light Co. v. Dept. of Revenue,* File No. K07-R-20 (Order K-20663, March 23, 2010). The Department appealed the Board's ruling to the Franklin Circuit Court.

Circuit Court Finds Department's Position Does Not Violate Contemporaneous Construction Because There Was No Ambiguity in The Statutes and the Department Had No Long-standing Policy of Spreading the Franchise Among Classes of Property.

The Franklin Circuit Court reversed the ruling of the Board, holding that the Department's past practices were incorrect and that its new method was correct under Kentucky's PSC Tax scheme. *Dept. of Revenue v. Dayton Power & Light Co.*, Civil Action No. 10-CI-624, Franklin Circuit Court, (July 12, 2011). The circuit court noted that there was no evidence of any reliance by DPL on an unbroken administrative interpretation of an ambiguous statute, but the past application of the Department's interpretation was in the context of the negotiation of settlement of contested tax liabilities. DPL appealed the circuit court's decision to the Kentucky Court of Appeals.

Court of Appeals' Majority Decision Upholds the Department's Position and Holds the Doctrine of Contemporaneous Construction Was Not Violated.

The Court of Appeals initially affirmed the circuit court's decision in an unpublished opinion. *Dayton Power & Light Co. v. Dept. of Revenue,* 2011-CA-001438 (Ky. App. Aug. 10, 2012). The Court then granted DPL's Petition for Rehearing, withdrew the original opinion, and entered a virtually identical opinion, which was designated for publication. There was a vigorous dissent by one member of the three-judge panel. DPL filed a Motion for Discretionary Review with the Kentucky Supreme Court, which remains pending.

The Court of Appeals initially noted that KRS 136.120(2)(c) requires the property of a public service company to be taxed at the "same rates" as non-public service companies. However, the Court then determined that DPL's franchise fell within the catch-all provision of KRS 132.020(1)(r) and was therefore subject to the $0.45/$100 tax rate and full local taxation. The Court reasoned that none of the categories and rates in KRS 132.020(1)(a) – (q) were applicable, and therefore, the catch-all provision applied. The Court also found that non-public service companies do not have taxable franchises and thus, there was no "same rate" to apply. Observing the 17 categories of property and tax rates in KRS 132.020(1)(a)-(q) and KRS 132.200, the Court held that had the legislature intended to tax franchises at a lower rate or exempt them from local taxation, the legislature would have done so. The Court also opined that although intangible property is generally exempt from tax, intangible property assessed under KRS Chapter 136 (PSC Tax) is taxable.

The Court then reviewed and rejected DPL's argument that the doctrine of contemporaneous construction was applicable. The Court indicated that under the contemporaneous construction doctrine, if an

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administrative agency has a long-standing policy under which it has interpreted an ambiguous statute, it may not change its position without a change in applicable law. *GTE v. Revenue Cabinet,* 889 S.W.2d 788, 792 (Ky. 1994) (superseded on other grounds by statute as recognized in *Miller v. Johnson Controls*, 296 S.W.3d 392 (Ky. 2009).

The Court held that the PSC Tax scheme was not ambiguous and there was no evidence of record to demonstrate that the Department had a long-standing policy of spreading the tax rates among the various classifications of property. The Court found, instead, that the case involved an example of an administrative agency's correcting itself once it determined it had made a mistake. The Court therefore held that the Department complied with the law when it corrected its mistake, since contemporaneous construction may not be invoked to memorialize or to ratify a mistake of an agency and an erroneous interpretation of law may not be perpetuated.

Dissenting Opinion Concludes PSC Tax Statutes Are "Inherently Ambiguous."

The dissent argued that the doctrine of contemporaneous construction was applicable because the PSC Tax statutes were "inherently ambiguous" and that the Department is required to adhere to its previous interpretation of the law. The dissenting judge reasoned: "The fact, however, that the statute can reasonably be interpreted two ways is indicative of ambiguity, and as much as I try, I do not see the clarity of the method of taxation. The Department is bound by its prior interpretation."

Discretionary Review by Kentucky Supreme Court

DPL has sought review of this decision by the Kentucky Supreme Court; and as of the date of publication of this article, DPL's motion is still pending. Although review of appellate decisions is purely discretionary, the Kentucky Supreme Court should grant review in this case as there are clearly "special reasons" as required for review. *See, CR 76.20(1).*

The Court of Appeals' decision to uphold the Department's separate taxation of DPL's franchise is a case of first impression in Kentucky, and will substantially increase every public service company's PSC Tax. The affected taxpayers include railway companies, sleeping car companies, chair car companies, dining car companies, gas companies, water companies, bridge companies, street railway companies, interurban electric railroad companies, express companies, electric light companies, electric power companies, commercial air carriers, air freight carriers, pipeline companies, privately owned regulated sewer companies, municipal solid waste disposal facilities, railroad car line companies and every other like company or business performing any public service. *See, KRS 136.120(1)(a).*

Further, the PSC Tax scheme is arguably arbitrary, ambiguous and subject to different interpretations, as demonstrated by the Department's alleged policy for several years of allowing the spreading of the franchise among property classes, but then reversing its position in 2006 and requiring separate taxation of the franchise. The Kentucky Supreme Court should grant review of the *DPL* case to determine whether the Court of Appeals erred in upholding the Department's application of the PSC Tax scheme, and whether Section 2 of the Kentucky Constitution (prohibiting arbitrary state action) and the doctrine of contemporaneous construction were violated by the Department's actions in changing its method of taxing public service companies with no change in applicable law.

The Department's actions here appear to be similar to its actions in a sales tax case where it changed its administrative position with no corresponding change in the law. There, the Court held that the doctrine of contemporaneous construction applied to bar the Department's change in position. *See, Revenue Cabinet v. Humana, Inc.*, 998 S.W.2d 494 (Ky. App. 1998). The Court held in *Humana*:

> [I]f the statute contained no ambiguity, we can fathom no reason for Revenue's differing interpretations. . . . . For eighteen years, Revenue applied the statute in one manner. Suddenly it announced, without any legislative change, any public hearing, or any other logical reason, an opposite interpretation of the statute. Such arbitrary and naked exercise of power is forbidden by the Constitution of Kentucky, section 2; the contemporaneous construction doctrine is merely an application of that constitutional provision.

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The Court reasoned that the sales tax statutes at issue must have been ambiguous as demonstrated by the Department's interpretation for nearly 20 years that for-profit hospitals were entitled to the prescription drug exemption, despite its subsequent reversal of that position in a letter to hospitals that they were no longer entitled to the exemption and would be taxed on prescription drugs.

The *Humana* case also held that the Department violated KRS Chapter 13A, which forbids administrative agencies from expanding, limiting or modifying statutes, administrative regulations and constitutional rights via internal agency policies or memoranda, which provides another potential basis for the Supreme Court's review.

The *DPL* case also involves important questions of statutory interpretation, since the Court of Appeals' majority opinion is arguably contrary to the plain language of the PSC Tax statutes.

The Court should also review whether Kentucky Constitution Section 171, requiring uniformity in taxation of property, was violated by the Department's disparate tax treatment of public service companies and non-public service companies.

Because the *DPL* case involves novel questions of constitutional and property tax law affecting hundreds of public service company taxpayers, the Kentucky Supreme Court should grant review.

INCOME TAX

Illinois Amnesty - Is it Better to Be Safe Than Sorry?

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In 2003, Illinois enacted the Amnesty Act which provided amnesty to taxpayers who paid "all taxes due" for any taxable period after June 30, 1983 and prior to July 1, 2002. To participate in the amnesty program, taxpayers had to make full payment of all taxes due during the amnesty period of October 1, 2003 through November 17, 2003 ("amnesty period"). If a taxpayer eligible for amnesty did not participate in amnesty, the statute provided for "double interest," interest imposed at 200% the statutory rate.

Pursuant to the Amnesty Act, the Illinois Department of Revenue ("Department") enacted Emergency Rules which provided a taxpayer who was under federal audit may participate in amnesty by making a good faith estimate of the increased liability that may be owed to the Department. In addition, the Emergency Rules stated that although participants in the amnesty program may not seek refunds, a limited exception to this rule will be permitted for taxpayers whose refund claims are based upon final determinations of the Internal Revenue Service ("IRS").

With this background, three similarly-situated corporate taxpayers took two different routes with respect to the 2003 Illinois amnesty program with three different outcomes. The first taxpayer, Con-Way Transportation Services ("Con-Way"), was in the midst of a federal audit for the 1997 tax year during the amnesty period. On November 17, 2003, Con-Way participated in amnesty by filing a First Amended Return and making a good faith estimate of additional Illinois tax due based on the federal changes it anticipated.

Con-Way received a final determination of its federal changes in August 2004, nine months after the expiration of the amnesty period. On November 29, 2004, more than one year after the good faith estimate was paid, Con-Way

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