COST SPRING 2015
<u>Kentucky State and Local Tax Developments</u>

Timothy J. Eifler
Direct Dial: (502) 560-4208
Email: timothy.eifler@skofirm.com

Stephen A. Sherman
Direct Dial: (502) 568-5405
Email: stephen.sherman@skofirm.com

Stoll Keenon Ogden PLLC
500 West Jefferson Street, Suite 2000
Louisville, KY 40202

Erica L. Horn
Direct Dial: (859) 231-3037
Email: erica.horn@skofirm.com

Jennifer S. Smart
Direct Dial: (859) 231-3619
Email: jennifer.smart@skofirm.com

Stoll Keenon Ogden PLLC
300 West Vine Street, Suite 2100
Lexington, KY 40507

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Lexington, KY 40507

I. INCOME/FRANCHISE TAXES.

A. Legislative Developments.

1. 2015 HB 331 (BR 1114) (Failed)

HB 331 stalled in the House Appropriations and Revenue Committee. The bill proposed to amend the limited liability entity tax statutes (KRS 141.0401) to expand the definition of "cost of goods sold" to include the same costs allowed by the Internal Revenue Code. This bill was proposed in reaction to assessments issued by the Kentucky Department of Revenue ("KDOR") denying taxpayers various items claimed as cost of goods sold.

2. 2015 HB 374 (BR1104) (Failed)

HB 374 also stalled in the House Appropriations and Revenue Committee. The bill proposed to amend the income tax statutes to require combined reporting of business income; implement a throwback rule; disallow tax haven transactions; and implement a Kentucky earned income tax credit.

B. Judicial Developments.

1. *World Acceptance Corporation, et al. v. Commonwealth of Kentucky, Finance & Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, File No. K13-R-18, Order No. K-24682 (August 29, 2014), appealed to Franklin Circuit Court, Civil Action No. 2014-CI-1193 (September 29, 2014) (Pending).

World Acceptance Corporation ("WAC") and its wholly-owned subsidiary, World Finance Corporation of Kentucky ("WFCKY") (collectively "Taxpayers") appealed the KDOR's denial of its income tax refund claims for tax years 2007 through 2010. The issue presented is whether WAC and WFCKY are required by Kentucky law to file consolidated Kentucky corporation income tax returns for the relevant periods. Kentucky requires a "common parent corporation doing business in this state" to file a consolidated tax return if the parent owns more than 80% in stock and value of the subsidiary.

The controversy emanates from KDOR providing a letter ruling stating the Taxpayers should file consolidated returns and then reversing its position after the consolidated returns resulted in significant refund claims.

The KDOR claims the parent, WAC, must, but does not, meet the definition of "includible corporation" because WAC was a corporation realizing a net operating loss whose property, payroll and sales factors were de minimis. According to KDOR, such corporations are excluded from the definition of "includible corporation" and therefore, cannot file a consolidated return. The Taxpayers argue the definition of "includible corporation" applicable to a "common parent corporation" is set forth at KRS 141.200(9)(b), and, even if KDOR was correct that KRS 141.200((9)(e)(7) is applicable, WAC's apportionment factors were not *de minimis* (per KDOR's own letter ruling).

The Kentucky Board of Tax Appeals ("KBTA") failed to hold the KDOR to its letter ruling, rejected the arguments of the Taxpayers and affirmed the KDOR's denial of the Taxpayers' refund claims. The Taxpayers have appealed to the Franklin Circuit Court where briefing has been completed and oral argument will be held on April 29, 2015.

The authors' firm represents the Taxpayers in this action.

2. *Department of Revenue v. AT&T Corporation*, Kentucky Court of Appeals, No. 2008-CA-001888-MR (July 3, 2014) (not to be published), *motion for discretionary review filed*, Kentucky Supreme Court, No. 2014-SC-430-D (August 1, 2014) (Pending).

In this case, the Kentucky Court of Appeals affirmed the judgment of the trial court holding the KDOR's denial of the taxpayer's refund claim was not supported by statute. The decision, if affirmed, will have limited applicability due to changes in Kentucky's statutes since the periods in question.

Today's version of KRS 141.200, Kentucky's consolidated filing statute, requires a corporation have *nexus* with Kentucky before the corporation may be included in a consolidated group. The version of KRS 141.200 at issue was for tax years 1995, 1996 and 1997 required corporations electing to file a consolidated return to use their federal consolidated affiliated group. This meant a corporation did *not* have to have nexus with Kentucky to be included in the consolidated group.

Initially, AT&T filed its corporation income tax returns using the federal consolidated group. Later, the corporation amended its returns to include only those corporations with nexus in Kentucky. Kentucky's nexus standard at the time was "physical presence". The court refers to the non-nexus companies as the "non-Kentucky subsidiaries". The amended returns reflected an overpayment by AT&T of approximately $5.7M.

The Court relied solely on rules of statutory construction and held KRS 141.200 ambiguous because the statutes stated *all* members of the affiliated group had to be included in the return, but the nexus statute provided only corporations owning or leasing property or paying compensation in the state were subject to income tax. AT&T's non-Kentucky subsidiaries did not own or lease property in Kentucky or pay compensation in the state. The Court concluded, "Therefore, [the non-Kentucky subsidiaries] cannot be taxed. … We are required to resolve ambiguities in taxing statutes in favor of the taxpayer. By doing so in this case, we find persuasive AT&Ts argument that only the Kentucky subsidiaries are to be included on the consolidated return …."

The KDOR filed a motion for discretionary review at the Kentucky Supreme Court. The KDOR's motion is pending.

C. Trends and Outlooks.

1. Combined Reporting and a Throwback Rule

Lawmakers likely will continue to pursue combined reporting and a throwback rule. While this has been an unsuccessful perennial pursuit in the Commonwealth, the endeavor appears to be picking up steam as the 2015 bill was supported by all of the leadership of Kentucky's House of Representatives. At least one hearing on the proposal has been promised before next year's legislative session.

2. Single Sales Factor Apportionment

It is expected taxpayers will continue to advocate for the adoption of a single sales factor apportionment method for determining Kentucky taxable net income. The proposal has been previously rejected based on its high price tag.

3. Cost of Goods Sold

Led by the Kentucky Society of CPA's, Kentucky practitioners will continue to pursue an amendment to the limited liability entity tax statutes (KRS 141.0401) to expand the definition of "cost of goods" sold to include the same costs allowed by the Internal Revenue Code.

II. TRANSACTIONAL/GROSS RECEIPTS TAXES.

A. Legislative Developments.

1. 2015 HB 1 (BR 107) (Failed)

HB 1 stalled in the Senate State and Local Government Committee. The bill proposed to amend Section 181 of the Constitution of Kentucky to authorize the General Assembly to confer upon any city or county the power to levy a local sales and use tax.

B. Judicial Developments.

1. *City of Florence v. Flanery*, Kentucky Court of Appeals, Case No. 2013-CA-001112 (November 7, 2014)(unpublished), *pet. for rehearing denied* (March 13, 2015).

In *City of Florence v. Flanery,* the Court found the tax imposed by KRS 136.600 et seq. to be unconstitutional and void. The case arose from the enactment in 2005 of certain taxes on providers of communications and multichannel video programming services (the "Telecommunications Tax"). KRS 136.660, a part of the taxing scheme, prohibits local governments from collecting franchise fees from such providers.

A number of Kentucky cities and the Kentucky League of Cities challenged the constitutionality of the Telecommunications Tax in a declaratory judgment action filed in Franklin Circuit Court. The cities claimed the tax impairs their right to levy franchise fees against providers of communications and multichannel video programming services in violation of Sections 163 and 164 of the Kentucky Constitution.

Prior to the enactment of the Tax, local governments collected franchise fees directly from certain providers and received a portion of the public service company property taxes imposed by the State. The Telecommunications Tax allows local governments to require franchises but prohibits the collection of franchise fees. Instead, a portion of the funds generated through the Telecommunications Tax are disbursed by the State to the political subdivisions in lieu of locally collected franchise fees.

The cities claim the distributed funds do not fully compensate them for their lost tax and franchise fee revenues. The cities maintain the Telecommunications Tax is unconstitutional because it deprives them of a right to levy franchise fees granted by Sections 163 and 164 of the Kentucky Constitution. Section 163 prohibits utilities from erecting infrastructure within a city or town "without the consent of the proper legislative bodies or boards of such city or town being first obtained", i.e., a franchise. Section 164 prohibits municipalities from issuing franchises for periods longer than twenty years and requires franchises to be awarded to the highest and best bidder following a public solicitation. In addition to state officials, the Kentucky CATV Association, Inc., a trade association representing cable television providers, is a defendant in the action.

The Franklin Circuit Court issued its opinion on June 5, 2013, granting the defendants judgment on the pleadings. The court held that despite any shortfall in payments to the cities, the Telecommunications Tax and its prohibition on local franchise fees was a constitutionally permissible exercise of legislative authority. The court held that Sections 163 and 164 of the Kentucky Constitution did not prohibit the General Assembly from exercising control over the levy and collection of franchise fees.

The Court of Appeals reversed the lower court holding local governments have the constitutional right to grant franchises and collect franchise fees and the Telecommunications Tax improperly abrogated those rights. The Court stated that the General Assembly may not abridge a constitutional delegation of authority by legislative action; such an act requires a constitutional amendment. Therefore, the Court held the Telecommunications Tax was void.

At this time, it is not known whether review by the Kentucky Supreme Court will be sought.

The authors' firm represents the Kentucky CATV Association, Inc. in this action.

2. *Praxair, Inc. v. Department of Revenue*, KBTA, File No. K12-R-26, Order No. K-24716 (Nov. 19, 2014), appealed to Franklin Circuit Court, Civil Action No. 2014-CI-1507 (December 18, 2014) (Pending).

In *Praxair, Inc. v. Department of Revenue*, the KBTA held that respiratory therapy devices, including CPAPs, BiPAPs, VPaps and AUTOPAPs, were subject to sales and use tax despite Medicare or Medicaid paying for all or a portion of the costs. The KBTA found the governmental exemption from sales tax was inapplicable because the legal incidence of sales tax fell upon the retailer and not Medicare or Medicaid. The KBTA also affirmed the KDOR's imposition of penalties finding that Praxair did not meet its burden of showing that it qualified for a penalty waiver.

The taxpayer has appealed to the Franklin Circuit Court.

3. *Virgin Mobile USA, L.P. v. Commonwealth of Kentucky ex rel. Commercial Mobile Radio Service Emergency Telecommunications Board,* 448 S.W.3d 241 (Ky. 2014).

In this case, Virgin Mobile USA, LP ("Virgin Mobile") challenged the imposition of the Commercial Mobile Radio Service ("CMRS") "service charge" imposed under KRS 65.7629 prior to July 2006. Virgin Mobile remitted the CMRS service charge to the Commercial Mobile Radio Service Emergency Telecommunications Board ("CMRS Board") from 2002 through 2005. However, rather than collecting the tax from its customers, Virgin Mobile remitted the tax from its general revenues. Virgin Mobile stopped remitting the tax in June 2005 and requested refunds of all prior payments after learning that several national tax reporting agencies had determined the service charge did not apply to prepaid wireless services. The CMRS Board refused to issue the refunds. After the statutes were amended in July 2006 to clearly apply to prepaid wireless connections, Virgin Mobile began crediting its prior payments against the services charges. Virgin Mobile began remitting tax in November 2008 after exhausting its credit.

The CMRS Board filed suit against Virgin Mobile in Jefferson Circuit Court, which held for the CMRS Board, awarding it the service charges, as well as additional amounts, that Virgin Mobile did not remit between 2005 and 2007. The Court of Appeals affirmed the circuit court and determined that Virgin Mobile was a CMRS provider subject to the tax. The court determined that the 2006 amendments changed only the permissible methods of collection and not the duty to collect. The court also held that because it affirmed the circuit court in finding that the pre-2006 statute applied to Virgin Mobile and it was required to collect the charges in question, the issue of whether it was entitled to a refund or credit was moot and it declined to address the issue further.

The Kentucky Supreme Court granted motions for discretionary review filed by Virgin Mobile and the CMRS Board and noted that the issues before it were disputed questions of law; thus, its review would be de novo. The Court next stated that it would be guided by the rule of statutory construction that the intention of the General Assembly must be ascertained and given effect.

The Court first addressed Virgin Mobile's argument that the lower court erred in holding that the CMRS service charge applied to it prior to the July 2006 amendments. The Court found that Virgin Mobile was entitled to summary judgment holding that it was not required to collect from its prepaid customers a CMRS service charge prior to July 2006. In reaching this conclusion, the Court analyzed the language of the pre-2006 statute, finding that Virgin Mobile did not provide monthly billing and therefore could not be a "billing provider" under the pre-2006 statute's mandatory collection procedure. The Court noted that it could "reasonably find" an intent by the General Assembly in the pre-2006 statute that all wireless customers pay the CMRS charge. But, the Court abided by the plain language of the statute, concluding that the plain language showed no intention to require all CMRS providers to collect the service charge, but rather, only "billing providers" that sent monthly bills to their customers.

The Court next addressed whether Virgin Mobile was entitled to a refund of amounts mistakenly paid or a credit for such amounts against post-July 2006 charges. The Court summarily rejected Virgin Mobile's refund claim, stating that because Virgin Mobile repaid itself by setoff, the issue of refund was not properly before the Court. The Court found that because Virgin Mobile used a credit, it had the money in hand and was not due a refund.

The Court proceeded to discuss Virgin Mobile's credit/recoupment claim. The Court rejected Virgin Mobile's claim that KRS 134.580 authorized a refund or credit on the basis that CMRS charges are paid into the CMRS Fund and not "into the State Treasury" as required by the statute. Noting the merits of Virgin's common law refund claim, the Court nevertheless rejected it on the basis that such claims involved the right to refund which the Court already had found not to be at issue. The Court noted that had Virgin mobile remitted the amounts when due, and timely filed an action for a refund, the common law right to a refund would have been proper. The Court concluded that Virgin Mobile's erroneous payment of pre-2006 CMRS charges did not justify its failure to make the required payments after July 2006. The Court found no authority for Virgin Mobile's recoupment by credit.

Ultimately, the Court affirmed the Court of Appeals insofar as it affirmed the trial court's judgment that Virgin Mobile was liable for the underpayment of post-July 2006 CMRS fees totaling $286,807.20. As a result, the CMRS Board will have an award against Virgin Mobile for this amount based on failure to remit post-2006 CMRS fees, despite the Court's finding that Virgin Mobile was not required to originally pay that amount under the pre-2006 statute and that Virgin Mobile could have initiated an action to recover the erroneously paid CMRS charges. The Court reversed the Court of Appeals on the issue of attorney's fees, concluding that the resolution of the case was mixed with Virgin Mobile winning on the pre-2006 issue and the

CMRS Board winning on the post-2006 issue. The Court found the attorney's fee issue must be reassessed by the trial court, taking into account the extent of each party's success in determining whether to award attorney's fees.

Virgin Mobile's petition for rehearing was denied on December 18, 2014 and the opinion of the Court is now final.

The authors' firm represented Virgin Mobile in this action.

4. *Ohio Valley Aluminum Company, LLC v. Department of Revenue*, Kentucky Court of Appeals, 2013-CA-000507 (September 12, 2014), *motion for disc. rev. filed*, Kentucky Supreme Court, 2014-SC-619-D (October 13, 2014).

This case addresses the doctrine of substance over form and the use of "tolling agreements" for purposes of the partial exemption from sales tax of energy and energy-producing fuels used in manufacturing.

Kentucky's statutory scheme provides an exemption from sales and use taxes and the utility gross receipts license tax ("UGRLT") for energy or energy-producing fuels used in the course of manufacturing to the extent that the cost of energy exceeds three percent of the "cost of production". Taxpayers are required to submit an application for an energy direct pay authorization ("EDPA") to the KDOR. If granted, taxpayers then pay an estimated use tax each month directly to the KDOR, rather than to their energy provider. In the application, the taxpayer provides its "cost of production" and costs related to energy and energy-producing fuels based upon costs incurred in the last completed fiscal or calendar year.

The KDOR denied the application of Ohio Valley Aluminum Company, LLC ("Ohio Valley") for an EDPA, and denied the company's related refund claims for overpayments of UGRLT and sales and use taxes. The KDOR based its denial on Ohio Valley's failure to include in its cost of production the cost of raw or scrap aluminum. Ohio Valley argued it was not required to include the cost of the raw aluminum because those materials were owned by its wholly-owned subsidiary, OVACO, and Ohio Valley was merely acting as a "tolling facility" pursuant to a tolling agreement with OVACO.

The KDOR previously has recognized "tolling agreements". In such agreements, the toller is not required to include the cost of raw materials in its cost of production.

The evidence indicated that Ohio Valley and OVACO had entered into a tolling agreement where OVACO owned the raw aluminum and Ohio Valley processed it into billets for a fee. The KDOR argued, however, that the relationship in operations between Ohio Valley and OVACO were not "separate and distinct" as required by the applicable case law in order for the cost of the aluminum to be separated from Ohio Valley's cost.

The Court of Appeals agreed that Ohio Valley's aluminum casting operation was not "separate and distinct" from OVACO, which *existed on paper only and had no employees*. The Court determined that Ohio Valley was engaged in only one operation at its plant (where it melted raw and scrap aluminum and cast it into billets), had only one plant facility, and that all costs associated with the production of the aluminum billets should be included in "cost of production".

The Court applied the "substance over form" doctrine holding that the substance of the relationship between OVACO and Ohio Valley evidenced a single entity, rather than two distinct entities. The Court specifically noted that *the entities shared a single bank account, shared employees,* and Ohio Valley was the sole member of OVACO.

A motion for discretionary review to the Kentucky Supreme Court has been filed and is under consideration.

5. *Sam's East, Inc. v. Department of Revenue*, KBTA File No. K13-R-21 and *Wal-Mart East v. Department of Revenue*, KBTA File No. K13-R-20, Order No. K-24665 (June 27, 2014), appealed to Franklin Circuit Court, Civil Action No. 14-CI-00870 (July 14, 2014)(Pending).

In these cases, the KBTA addressed the constitutionality of budget bill provisions relating to taxation. Before attempts to amend the statute, a vendor could retain 1.5% of the first $1,000 of sales tax collected by it and 1% of the amount in excess of $1,000 per month. The Legislature in the 2003, 2005 and 2006 budget bills attempted to impose a limit of $1,500 per month on the amount of vendor compensation notwithstanding KRS 139.570. In 2009, the Legislature repealed and reenacted KRS 139.570 to include the $1,500 compensation limit and stated the limit was retroactive to July 1, 2003. For the periods of July 1, 2003 – June 30, 2004 and July 1, 2005 – June 30, 2008, Wal-Mart and Sam's remitted the sales tax collected and withheld $1,500 as vendor compensation.

In September 2008, Wal-Mart and Sam's submitted refund claims to the KDOR for vendor compensation owed to them over the $1,500 limit. The taxpayers argued the budget bills violated § 51 of the Kentucky Constitution because inclusion of the compensation limit - (1) violated the "single subject" requirement of the section because the bill addressed both appropriation and taxation; (2) § 51 was violated because the subjects of the budget bills failed to reflect the inclusion of tax items; and (3) § 51 was violated because KRS 139.570 was not reenacted in its entirety when amended. Alternatively, the taxpayers argued the vendor compensation limits expired along with the budget bills and the limits are no longer in effect.

The KDOR denied the refund request ruling the refund claims were barred by the two year statute of limitations in KRS 134.590. The taxpayers appealed to the KBTA, which consolidated the cases before ruling it did not have jurisdiction over the taxpayers' constitutional challenges. As a result, the KBTA denied the taxpayers' motion for summary disposition and upheld the final rulings of the KDOR.

The taxpayers appealed the KBTA's Order to the Franklin Circuit Court. Briefing is complete and the case is under submission.

6. *Interstate Gas Supply, Inc. for use and benefit of Tri-State Healthcare Laundry, Inc. v. Department of Revenue, Finance and Administration Cabinet*, Franklin Circuit Court, Civil Action No. 12-CI-00947 (September 13, 2013), appealed to Kentucky Court of Appeals, Case No. 2013-CA-001766 (Pending).

Interstate Gas Supply, Inc. ("IGS"), an Ohio natural gas marketer, sought refunds of use tax collected and paid on sales of natural gas by IGS to Tri-State Healthcare Laundry, Inc. ("Tri-State"). Tri-State is a joint-cooperative laundry association owned by several non-profit charitable hospitals in Northern Kentucky. IGS collected use tax on its natural gas sales to Tri-State and remitted the tax to Kentucky.

IGS—on behalf of Tri-State—claimed a refund for all use tax paid on Tri-State's natural gas purchases. IGS claimed that Tri-State is exempt from use tax pursuant to § 170 of the Kentucky Constitution. Section 170 exempts from taxation institutions of purely public charity and states, in relevant part:

> There shall be exempt from taxation public property used for public purposes; places of burial not held for private or corporate profit; real property owned and occupied by, and personal property both tangible and intangible owned by, institutions of religion; institutions of purely public charity . . .

Tri-State was previously determined by the KDOR to be an institution of "purely public charity." Nevertheless, the KDOR denied IGS's refund request, claiming that § 170 only extends to property taxes and that the use tax is not a property tax. The KDOR relied heavily upon *Children's Psychiatric Hospital of Northern Kentucky v. Revenue Cabinet*, 989 S.W.2d 583 (Ky. 1999) ("*Children's Psych.*"), as the basis for its decision. In *Children's Psych.*, the Supreme Court of Kentucky held that the § 170 exemption does not extend to the Kentucky healthcare provider tax. The KDOR claimed that the court's ruling in *Children's Psych.* limited all exemptions in § 170 to property taxes. On appeal the KBTA affirmed the ruling of the KDOR.

IGS appealed the decision of the KBTA to the Franklin Circuit Court. The court affirmed, concluding that § 170 of the Kentucky Constitution only exempts institutions of purely public charity from the payment of property taxes. The court relied upon *Children's Psych.* as the basis for its decision, finding it to be the most recent case interpreting the § 170 charitable exemption. The court found that *Children's Psych.* "specifically held that the exemption only extended to property or ad valorem taxes," and since the use tax is not a property tax, the exemption did not apply. Therefore, the court found that Tri-State was not entitled to a refund on the use tax paid on its purchases of natural gas from IGS.

The case is pending at the Court of Appeals.

The authors' firm represents IGS/TSHL in the action.

7. *Progress Metal Reclamation Company v. Commonwealth of Kentucky, Finance & Administration Cabinet, Department of Revenue,* Kentucky Court of Appeals, Case Nos. 2013-CA-1765 and 2013-CA-1776 (March 13, 2015)(Pending).

In this case, the Kentucky Court of Appeals addresses the tension arising in one of Kentucky's sales and use tax statutes related to a manufacturing exemption. While KRS 139.470(11) allows an exemption for industrial tools "directly used in manufacturing or industrial processing" and having a "useful life of less than one (1) year", the same statute excludes from the scope of the exemption "repair, replacement, or spare parts". Controversies frequently arise as a result of the requirement that industrial tools have a useful life of less than one year and the exclusion of repair and replacement parts.

"Industrial tools" are defined as: "[H]and tools such as jigs, dies, drills, cutters, rolls, reamers, chucks, saws, spray guns, etc., and to tools attached to a machine such as molds, grinding balls, grinding wheels, dies, bits, cutting blades, etc. Normally, for industrial tools to be considered directly used in manufacturing, they shall come into direct contact with the product being manufactured." The term "repair, replacement, or spare parts" is defined by KRS 139.010(26) (previously KRS 139.170(4)) to mean "any tangible personal property used to maintain, restore, mend, or repair machinery or equipment."

Progress Metal Reclamation Company argued hammer pins used in its business of recycling and manufacturing scrap metal for steel mills were exempt as industrial tools, and also claimed liquid oxygen used in its cutting torch was exempt as an industrial supply. KDOR issued a final ruling holding the hammer pins were not industrial tools and the liquid oxygen was an energy producing fuel, not an industrial supply, so neither was exempt from sales tax.

Progress Metal appealed the KDOR's determinations to the KBTA wherein the testimony established the hammer pins hold hammers in place on rotors that break up metal. Progress Metal argued the hammer pins qualify for the exemption from tax because they function as chucks or tool holders, which are expressly listed in the statute. Furthermore, Progress Metal argued the hammer pins have a useful life of less than one year. The KDOR, by contrast, argued the hammer pins did not qualify for the exemption because they were repair or replacement parts. The KBTA agreed with the KDOR and held the hammer pins were not industrial tools but repair parts.

Progress Metal also argued liquid oxygen used in an oxy-fuel torch cutting process to cut large pieces of metal into smaller pieces was exempt from tax as an industrial supply. KRS 139.470(11)(a)2.b. defines this exemption to include "supplies such as lubricating and compounding oils, grease, machine waste, abrasives, chemicals, solvents, fluxes, anodes, filtering materials, fire brick, catalysts, dyes, refrigerants, explosives, etc." Furthermore, the company claimed the KDOR previously had exempted liquid oxygen from 1965 to 2004 but changed its position in 2004, despite no change in the law, thus violating the doctrine of contemporaneous construction. The KBTA noted the KDOR failed to address Progress Metal's argument regarding the doctrine of contemporaneous construction, and the KDOR did not argue liquid oxygen was not an industrial supply. The KBTA, therefore, reversed the KDOR's final ruling as to the liquid oxygen.

Both parties appealed to the Franklin Circuit Court. The circuit court affirmed, finding the KBTA's decision was based on substantial evidence and a reasonable interpretation of the law. Both the KDOR and Taxpayer filed appeals, which were consolidated in the Court of Appeals.

On March 13, 2015, the Court of Appeals issued an opinion affirming the Franklin Circuit Court's decision in full. The Court first addressed the KDOR's classification of liquid oxygen, and agreed with the circuit court and the KBTA that the doctrine of contemporaneous construction applied. Thus the Court held the KDOR to its longstanding treatment ("four-decade long pattern of exemption") of liquid oxygen as an industrial supply. The Court noted that it need not resort to the doctrine of contemporaneous construction in the absence of an ambiguity, but found an ambiguity existed.

With respect to Progress Metal's use of hammer pins, the Court agreed with the KBTA and the circuit court that the hammer pins were not "industrial tools" but instead were "replacement parts" not exempt from taxation. Like the circuit court, the Court noted that, at best, the hammer pins came into only incidental contact with the metal the mechanical hammer was destroying, and the hammer pins simply "wore out" and were not intended to be "used up" in the manufacturing process.

The parties have 30 days from the court's decision to file a motion for discretionary review with the Supreme Court of Kentucky.

8. *Warren Rural Electric Cooperative Corporation v. Finance and Administration Cabinet, Department of Revenue*, KBTA File No. K13-R-34 (Pending).

This case involves the taxability of transactions between Warren Rural Electric Cooperative Corporation ("Warren RECC") and multiple software vendors for the provision of software maintenance services. On October 16, 2013, the KDOR issued a Final Ruling affirming the assessment of sales and use tax against Warren RECC on various software maintenance and support charges claiming the software at issue is "prewritten" software, and any maintenance fees charged in connection with the software constitute a part of a "bundled transaction" and therefore, are subject to sales and use tax.

"Prewritten" software is subject to sales and use tax in Kentucky, but "custom" software is not. Although custom software is not defined by Kentucky law, what constitutes custom software can be inferred from the definition of prewritten software. KRS 139.010(22)(a) defines prewritten software as "[c]omputer software, including prewritten upgrades, that are ***not*** designed and developed by the author or other creator to the specifications of a specific purchaser". (Emphasis added). Under KRS 139.010(22)(b), prewritten software also includes "[s]oftware designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the original purchaser". Finally, KRS

139.010(22)(c) states that modifications and enhancements to prewritten software made by someone other than the author or creator do not constitute prewritten software if there is a reasonable, separately stated charge for the modification or enhancement. Additionally, the KDOR maintains that software maintenance agreements with respect to prewritten software are taxable unless they are optional agreements for support services only and do not include software updates and upgrades.

Warren RECC appealed the KDOR's Final Ruling, and the case currently is pending before the KBTA. Warren RECC is arguing the software at issue is custom software designed and developed by the authors and creators of the software to the specifications of Warren RECC. Because the software at issue is custom software, the corresponding maintenance charges also are exempt from sales and use tax. The KDOR, by contrast, claims the software is prewritten and marketed to many rural electric cooperatives, despite the fact the software is designed and developed to meet each cooperative's specific needs.

The case currently is in the discovery stage and has been scheduled for an evidentiary hearing before the KBTA on August 26, 2015.

The authors' firm represents Warren RECC in this case.

9. *Netflix, Inc. v. Commonwealth of Kentucky, Finance & Administration Cabinet, Department of Revenue*, KBTA File Nos. K13-R-31 and K13-R-32 (Pending).

Netflix has filed two petitions of appeal at the KBTA challenging the KDOR's denial of Netflix's refund claims of the gross revenues tax and excise tax on multichannel video programming, imposed pursuant to KRS 136.616 and KRS 136.604, respectively; and the utility gross receipts license tax. The disputes apply only to Netflix's streaming services and not its DVD rental business. The issue is whether Netflix's streaming service is a "multichannel video programming service" ("MVPS") subject to any of the taxes.

MVPS is defined by Kentucky's statute as "*programming provided by or generally considered comparable to programming provided by a television broadcast station* and shall include but not be limited to: (a) Cable service; (b) Satellite broadcast and wireless cable service; and (c) Internet protocol television . . . ." KRS 136.602(8)(emphasis added). Federal statutes define "video programming" in the same terms, namely as "*programming provided by, or generally considered comparable to programming provided by, a television broadcast station*." 47 U.S.C. § 522(20) (emphasis added). The federal definition is used for the purposes of identifying entities subject to regulation by the Federal Communications Commission. Netflix is not subject to such regulation.

A hearing was held before the KBTA in October 2014. In March 2015, the KBTA requested additional briefing on the question of whether Netflix meets the definition of "cable service", as that term is defined at KRS 136.602(1), which provides:

> "Cable service" means the provision of video, audio, or other programming service to purchasers, and the purchaser interaction, if any, required for the selection or use of the video or other programming service, regardless of whether the programming is transmitted over facilities owned or operated by the provider or by one (1) or more other communications service providers. Included in this definition are basic, extended, and premium service, pay-per-view service, digital or other music services, and other similar services.

A supplemental evidentiary hearing or oral argument will be held once briefing is complete.

The authors' firm is co-counsel for Netflix.

C. Trends and Outlooks.

1. Local Sales Tax and Taxation of Select Services

Lawmakers likely will continue to pursue a constitutional amendment to permit local jurisdictions to impose a local sales tax with the approval of affected voters, and seek to expand Kentucky's sales tax base to select services. Prior proposals for taxing services have sought to tax funeral services, industrial launderers, beauty salons, parking lots and garages, barber shops, general automotive repair, consumer electronics repair and maintenance, home and garden equipment repair and maintenance, re-upholstery and furniture repair and footwear and leather goods repair.

2. Apply sales tax to software as a service ("SAAS")

KDOR continues to seek legislation to impose sales and use tax on access to and use of software hosted by the seller or a third party.

III. PROPERTY TAXES.

A. Legislative Developments.

1. 2015 HB 20 (BR 71) (Passed)(Signed March 19)

HB 20 was signed into law by the Governor on March 19. The bill clarifies the standards for setting the value of motor vehicles that are 20 years old or older for property tax purposes. HB 20 applies to motor vehicles assessed on or after January 1, 2016.

2. 2015 HB 492 (BR 1101) (Failed)

HB 492 stalled in the House Appropriations & Revenue Committee. The bill proposed to create a new section of KRS Chapter 173 to clarify the process to be used by library taxing districts in levying ad valorem taxes. Introduced in reaction to the *Coleman* and *Kuhnhein* cases discussed below, the bill would have repealed KRS sections 173.710 and 173.790.

B. Judicial Developments.

1. *Coleman et al. v. Campbell Co. Public Library Bd. of Trustees*, Kentucky Court of Appeals, Case No. 2013-CA-000883-MR (March 20, 2015) and *Kuhnhein et al. v. Kenton Co. Public Library Bd. of Trustees*, Kentucky Court of Appeals, Case Nos. 2013-CA-000874-MR and No. 2013-CA-001010 (March 20, 2015).

In a joint decision in *Coleman et al. v. Campbell Co. Public Library Bd. of Trustees* and *Kuhnhein et al. v. Kenton Co. Public Library Bd. of Trustees*, the Kentucky Court of Appeals held that library districts formed by petition must set their rates in accordance with KRS 132.023 and not KRS 173.790. Both cases were initially filed as refund class actions challenging the method by which the library districts calculated their real property tax rates.

Under Kentucky law, library districts can be formed under a variety of different methods. Prior to July 13, 1984, and in accordance with KRS 173.790, library districts could be formed by filing a petition signed by 51% or more of the voters who voted in the last general election with the County Fiscal Court. The petition had to specify the property tax rate to be levied to fund the district. The statute also provides that the property tax rate for a library district created by the petition method prior to July 13, 1984, cannot be increased or decreased without prior approval of the voters.

Taxpayers in Kenton and Campbell counties brought suit against the library districts, asserting that the districts increased their tax rates despite the fact that no petitions had been filed in accordance with KRS 173.790. The library districts argued that this requirement has been impliedly repealed by subsequent enactments of the General Assembly. Specifically, the library districts point to KRS 132.023, which was enacted in 1979 and sets forth a formula for calculating ad valorem property tax rates. From 1979 until the present, the library districts have utilized KRS 132.023 to calculate their tax rates. In their complaints, the taxpayers asserted the petition requirement in the library district statutes, as a more specific limitation only on library districts, controls over the more general limitations subsequently enacted by the legislature in KRS ch. 132.

In orders granting partial summary judgment in favor of the taxpayers, both the Campbell and Kenton Circuit Courts ruled the petition procedures outlined in KRS 173.790 had to be followed and that KRS 132.023 did not repeal the petition procedures. Thus, both courts held the increases in the property tax rates in the districts were improper. In the *Kuhnhein* case in Kenton Circuit Court, the judge ruled no refunds were due pursuant to the action because the plaintiffs had not met the requirements of KRS 134.590, Kentucky’s statute governing property tax refunds.

Both library districts appealed. In *Kuhnhein*, the taxpayers cross-appealed with regard to their refund claims. In a joint opinion, the Court of Appeals reversed the rulings of the circuit courts and found that the library’s properly determined their tax rates using KRS 132.023. The Court did not reach the cross-appeal issue of refunds.

The Court found that KRS 132.023 and KRS 173.790 should be read harmoniously, and held KRS 132.023(1) must be used to set the tax rate at the compensating tax rate, but when a library district seeks to increase its tax rate above the 4% compensating rate the district must comply with the petition requirement of KRS 173.790. The Court found support for its opinion in the fact that there had been no legislative action on the issue for over 30 years, the library districts had operated in good faith in compliance with directives of the executive branch, and to hold otherwise would adversely affect 80 library districts.

The taxpayers intend to seek discretionary review from the Kentucky Supreme Court.

2. *Grand Lodge F & A.M. and Springhill Village Retirement Community v. Kenton County PVA and City of Taylor Mill*, Case No. K12-S-69 (Ky. Bd. Tax App. Nov. 19, 2014), appeal filed, Kenton Circuit Court, 2014-CI-02367 (December 19, 2014)(Pending).

In *Grand Lodge F & A.M. and Springhill Village Retirement Community v. Kenton County PVA and City of Taylor Mill*, the KBTA held mere possession of a residential unit in a retirement community was not a taxable leasehold interest. Taxation of the alleged leasehold interest was attempted by the taxing authorities because the underlying property was exempt under Section 170 of the Kentucky Constitution. Section 170 exempts "real property owned and occupied by . . . institutions of purely public charity." The Grand Lodge of Kentucky, Free & Accepted Masons (the "Grand Lodge") has been recognized as a purely public charity since at least 1970.

A non-profit affiliate of the Grand Lodge built and owns the "Springhill Retirement Community" in Taylor Mill. While recognizing that Grand Lodge and its affiliate are tax-exempt, purely public charities, the property valuation administrator ("PVA") assessed the residential units to the residents as non-exempt possessors. The Grand Lodge and individual residents appealed these assessments to the KBTA.

The KBTA held the units were exempt from taxation under Section 170 of the Kentucky Constitution and the assessments issued for these units for the 2012, 2013, and 2014 tax years were void. An appeal has been filed with the Kenton Circuit Court.

3. *Chegg, Inc. v. Department of Revenue*, Franklin Circuit Court, Civil Action No. 14-CI-170 (October 29, 2014), appeal filed, Kentucky Court of Appeals, 2014-CA-001922 (November 25, 2014)(Pending).

In this case, the KBTA considered the scope of Kentucky's exemption from the tangible personal property tax for "goods stored in a warehouse". Chegg, an online text book rental company, argued that the textbooks qualified for the statutory exemption because they were rented by students and shipped out-of-state within six months of arriving at the facility. The KDOR argued that the statutory exemption is limited to items shipped out-of-state within six months that *never return to the state*. Because Chegg's textbooks were returned to Kentucky at the end of each semester, the KDOR argued the exemption was inapplicable.

The KBTA upheld the KDOR's assessment concluding that the "plain and ordinary meaning" of the phrases 'shipped out-of-state' and 'out-of-state destination' meant the item must be delivered out-of-state and not returned to Kentucky. Chegg appealed to the Franklin Circuit Court, which reversed the KBTA.

The circuit court found the exemption did *not* require: (1) the personal property is sent to a final or permanent destination; (2) a sale of the property; or (3) that the property owner proves, to any high degree of certainty, that the property will leave the state. The court found the plain language merely requires the property be sent to a destination outside of Kentucky and the property owner reasonably demonstrates the property will be shipped outside of Kentucky within six months.

The KDOR filed an appeal with the Kentucky Court of Appeals, which is currently pending.

4. *Wilson Equipment Co., LLC v. Commonwealth of Kentucky, Finance and Administration Cabinet, Department of Revenue*, KBTA File No. K13-R-13 (May 22, 2014), appealed to Franklin Circuit Court, No. 14-CI-00736 (June 13, 2014)(Pending).

In this case, the KBTA concluded that the tangible property tax exemption for equipment held under a floor plan financing arrangement is not limited to farm machinery and equipment, but that other types of "non-farm" equipment also qualify for the exemption.

The KBTA determined that Wilson Equipment Company, LLC ("Wilson") is a rental agency in the business of selling, retailing, leasing, renting and repairing machinery and equipment. Wilson reported certain property as exempt from local taxation on its 2004-2011 Kentucky tangible personal property tax returns pursuant to KRS 132.200(16). KRS 132.200(16) exempts from local taxation: "new farm machinery and other equipment held in the retailer's inventory for sale under a floor plan financing arrangement by a retailer as defined in KRS 365.800."

The KBTA found that under the clear wording of the statute, there are two categories of property exempt under KRS 132.200(16): (1) new farm machinery and (2) other equipment. To be exempt, both the new farm machinery and the other equipment must be held in the retailer's inventory for sale under a floor plan financing arrangement. In addition, the taxpayer must also be a "retailer" under KRS 365.800, which includes retailers engaged in the business of selling and retailing farm implements, tractors, farm machinery, utility and industrial equipment, and lawn and garden equipment. The KBTA held as long as equipment falls within a category set forth in KRS 365.800 and is held in a retailer's inventory for sale under a floor plan financing arrangement, it will be exempt from local taxation under KRS 132.200(16). The KBTA concluded the equipment at issue met this test and was therefore exempt from local taxation.

The KDOR has appealed the KBTA's ruling to the Franklin Circuit Court. Briefing was completed on December 12, 2014 and the case is under submission.

The authors' law firm represents Wilson Equipment in this case.

5. *Stearns Coal Company v. McCreary County Property Valuation Administrator*, KBTA Case No. K12-S-58 Order No. K-24471 (January 13, 2014), appealed to McCreary Circuit Court, Civil Action No. 14-CI-00026 (February 11, 2014)(Pending).

Stearns Coal Company ("Stearns") owned property located in McCreary County consisting of approximately 400 acres and improvements. Between 1992 and 2010, the property was valued at $1 million for property tax purposes. In 2011, a new property valuation administrator ("PVA") assessed the property at $10 million. Stearns appealed the PVA's value and the circuit court entered a value of $1 million for the 2011 year.

In 2012, the PVA again reassessed the property and valued it at $14 million. Stearns appealed to the local board of assessment appeals, which reduced the valuation to $12 million. Stearns then appealed to the KBTA.

Stearns presented separate appraisals of the land and improvements. Using comparable sales, Stearns' appraiser valued the land at $360,000. A second appraiser valued the improvements at $500,000. However, the appraisal for the improvements considered only the coal, preparation plant, and handling facilities; it did not value other improvements such as the mineshaft, elevator, shop building or office building. The PVA failed to offer any information to rebut Stearns' appraisals.

The KBTA held Stearns carried its burden of proof as it related to the land. The use of comparable sales by Stearns and the lack of evidence presented by the PVA were sufficient for the KBTA to rule for Stearns on the land value. The KBTA rejected, however, Stearns' valuation of the improvements because the valuation failed to account for all improvements on the property. The KBTA also found there was insufficient evidence to support the PVA's claimed value of $12 million. In setting its value, the KBTA used the 2011 agreed upon value of $1 million, subtracted the $360,000 value of the land and determined the improvements had a value of $640,000. The PVA has appealed the KBTA's decision to the McCreary Circuit Court.

IV. <u>OTHER TAXES/EXACTIONS.</u>

A. Legislative Developments.

None.

B. Judicial Developments.

1. *Ohio Valley Wholesale Distributors, Inc. v. Commonwealth of Kentucky et al.*, Boyd Circuit Court, Civil Action No. 13-CI-00209 (March 4, 2013)(Pending); and *OVWD, Inc. (Ohio Valley Wholesale Distributors, Inc.) v. Finance and Administration Cabinet, Department of Revenue*, KBTA File No. K13-R-15 (Pending).

In these actions, OVWD (fka Ohio Valley Wholesale Distributors, Inc.) is challenging the KDOR's assessment of cigarette and other tobacco products ("OTP") tax on OVWD's sales of untaxed cigarettes and OTP to out-of-state distributors. OVWD is a wholesale tobacco and convenience store merchandise distributor located in Ashland, Kentucky. The KDOR audited and assessed OVWD $11.5 million, including cigarette and OTP tax of $8.4 million plus interest, penalties and fees. The KDOR determined that the cigarettes and OTP in question were not actually sold to out-of-state distributors but to Superior Wholesale LLC, a licensed resident wholesaler located in Lexington, Kentucky.

The KDOR claims these transactions violated KRS 138.195 which provides that "[n]o person licensed under this section except nonresident wholesalers shall either sell to or purchase from any other such licensee untax-paid cigarettes." The KDOR further claims OVWD was required to stamp these cigarettes pursuant to KRS 138.146 prior to selling them to Superior Wholesale LLC and that OTP tax was similarly due on sales of OTP to resident, licensed wholesalers pursuant to KRS 138.140(4).

OVWD appealed to the KBTA. In its petition of appeal, OVWD alleges the cigarettes and OTP were sold to out-of-state distributors and, though admitting Superior Wholesale, LLC paid for the product, disputes the KDOR's determination that Superior was the actual purchaser. OVWD also claims the KDOR has no authority to directly assess cigarette tax against a cigarette licensee and that the KDOR's exclusive statutory enforcement mechanism is the seizure and sale of untax-paid cigarettes. OVWD further claims the KDOR's imposition of tax on cigarettes and OTP sold to out-of-state customers violates Section 2 of the Kentucky Constitution because it impedes the free flow of commerce and violates the Commerce Clause of the U.S. Constitution because it subjects such cigarettes to an undue risk of multiple taxation. OVWD claims that any tax owed is the obligation of OVWD's customers or Superior, not OVWD. OVWD also challenges the KDOR's assessment of penalties one year after issuing its assessments of tax as an arbitrary exercise of power in violation of Ky. Const. § 2.

In addition to the proceeding at the KBTA, the dispute has been brought to the courts. Prior to the issuance of the KDOR's Final Ruling, OVWD filed a declaratory judgment action in Boyd Circuit Court seeking a declaration that that the tax assessment violated the Kentucky and U.S. Constitutions because KDOR lacked statutory authority for the assessment and interfered the assessment with and discriminated against interstate commerce. It is unclear whether the parties will resolve the dispute at the KBTA or in the circuit court.

2. *Saint Joseph Health System, Inc. v. Department of Revenue*, KBTA Case No. K12-R-18 (Pending).

At issue before the KBTA in *Saint Joseph* is the application of the Kentucky provider tax on hospitals. After being denied refunds by the KDOR, Saint Joseph Health System, Inc. ("Saint Joseph") raised two issues on appeal, one of statutory construction and one of federal preemption. Saint Joseph filed a motion for partial summary judgment on the statutory construction issue. However, the KBTA denied Saint Joseph's motion. The federal preemption issue is now under consideration by the KBTA.

Saint Joseph argues the KDOR's application of the hospital provider tax for certain tax periods was erroneously applied to gross revenues received from federal health benefit plans and Medicare Advantage. Federal statutes and regulations include provisions expressly prohibiting state and local taxation of receipts of insurers of federal employees, current and retired members of the military and National Guard, and Medicare Advantage beneficiaries. Saint Joseph maintains these exemptions extend to receipts of the hospital from the insurers. The KBTA held oral argument on the issue on March 24, 2015.

The authors' firm represents Saint Joseph.

V. <u>OTHER NOTES OF INTEREST.</u>

A. Judicial Developments.

1. *Eye v. Board of Tax Appeals*, Ky. Ct. App., No. 2013-CA-000170-MR (Oct. 31, 2014) (not to be published), *motion for disc. rev. filed*, Kentucky Supreme Court, 2014-SC-000701 (Pending).

In *Eye v. Board of Tax Appeals*, Ky. Ct. App., No. 2013-CA-000170-MR (Oct. 31, 2014) (not to be published), the Kentucky Court of Appeals affirmed the circuit court's dismissal of various administrative parties named in a taxpayer's property tax appeal and the dismissal of the taxpayer's request for declaratory and injunctive relief. The Court held including such parties in the appeal and addressing such claims was unnecessary for the circuit court to grant the relief requested by the taxpayer.

Jason Eye, the taxpayer, appealed a decision of the KBTA to the Jefferson Circuit Court. The circuit court denied the taxpayer's request it vacate a settlement agreement he reached with the Jefferson County Property Valuation Administrator ("PVA"). Eye argued he signed the agreement under extreme duress from the hearing officer of the KBTA. As parties from whom he sought relief, Eye named various administrative agencies including the KBTA, the KDOR, and the Jefferson County Local Board of Assessment Appeal (the "Local Board"), as well as certain individuals and officials of those agencies. The Kentucky Court of Appeals affirmed the circuit court's dismissal of the administrative agencies and the individuals based on *LWD Equipment, Inc. v. Revenue Cabinet*, 136 S.W.3d 472 (Ky. 2004), in which the Kentucky Supreme Court held that naming an agency as a party on appeal is unnecessary because the agency would be bound by the decision of the reviewing court.

The Court also upheld the circuit court's dismissal of Eye's separate request for declaratory and injunctive relief finding that the relief sought could have been obtained by Eye at the circuit court by having the lower court remand the case to the KBTA. Therefore, the relief sought was superfluous.

The taxpayer has filed a motion for discretionary review with the Kentucky Supreme Court, which is currently pending.

2. 911 Funding – *Greater Cincinnati/Northern Kentucky Apartment Ass'n, Inc. v. Campbell County Fiscal Court,* Kentucky Supreme Court, Case No. 2014-SC-000383 (Pending).

On August 7, 2013, the Campbell County Fiscal Court adopted Ordinance O04-13, which replaces the $3.00 subscriber charge placed on each land line telephone with an annual fee of $45.00 imposed upon each occupied individual residential and commercial unit located in Campbell County. A civil action was commenced in Campbell Circuit Court challenging the legality of the ordinance. The lawsuit was filed by the Greater Cincinnati/Northern Kentucky Apartment Association, in conjunction with multiple owners of individual commercial and residential units located in Campbell County, and seeks to have the ordinance declared void *ab initio* because it levies an unauthorized and unconstitutional fee or tax. The plaintiffs asserted there are four legally prescribed methods by which a political subdivision in Kentucky, such as Campbell County, may collect funds from its residents: (1) special assessments; (2) regulatory fees and taxes; (3) user fees; and (4) revenue-raising fees and taxes, and the imposition of a flat fee (of $45.00 on owners of real property), does not satisfy the criteria of any of the four methods.

The County defended the lawsuit by arguing the 911 service charge is a valid user fee. The County argued all real property owners are "users" of 911 service because the service is available to everyone in the county and confers a benefit upon society at large. The plaintiffs countered that a valid user fee must be based upon actual use of the service, and owners of real property may never dial 911 and thus may never use the service for which they pay a fee.

The circuit court adopted a broad definition of "use" and found the plaintiffs are "users" of 911 service because the service is *available* to them should they need it. The plaintiffs appealed the circuit court's ruling to the Court of Appeals. The County then filed a motion to transfer at the Kentucky Supreme Court, and the Court granted the motion. Briefing at the Supreme Court is underway.

The author's law firm represents the plaintiffs in this litigation.

3. 911 Funding – *City of Lancaster v. Garrard County*, Kentucky Court of Appeals, Case No. 2013-CA000716-MR (July 3, 2014), *pet. for rehearing denied* (December 2, 2014), *mot. for disc. rev. filed,* 2014-SC-000739-D (Pending).

The Kentucky Court of Appeals has reversed and remanded a decision of the Garrard Circuit Court upholding Garrard County's 911 fee as a valid user fee. The facts leading to this lawsuit began nearly two years ago. On August 13, 2012, the Garrard County Fiscal Court adopted Ordinance O-08-12-1, which replaces the subscriber charge on landline telephones used to help fund 911 emergency telephone service with a fee of $0.25 imposed upon each and every water meter in Garrard County. The ordinance also requires every water company, water association in Garrard County to collect and remit the fees. On November 9, 2012, a civil action was commenced in Garrard Circuit Court challenging the legality of the ordinance. The lawsuit was filed against Garrard County, Kentucky, and the Garrard County Fiscal Court, alleging the ordinance is unconstitutional and collection of the fee is an unconstitutional taking of property.

While the circuit court upheld the validity of the ordinance, the Court of Appeals held the fee is not a valid user fee but instead an invalid tax. Appellants claimed the circuit court erred in granting summary judgment upholding the validity of the fee. The Court of Appeals agreed. The court noted that, under Kentucky case law, a valid user fee exists where there is a reasonable relationship between the fee charged and the benefit received. Generally, the court stated, a user fee is imposed upon the recipient of a benefit received from the government or for a particular government service. The court gave as examples of valid user fees tolls paid by drivers for the use of a particular highway or fees paid by individuals with landline phones for the benefit of 911 service. The court found the fee of $0.25 upon each water meter imposed by Garrard County's ordinance is not directly related to the benefit of 911 telephone service.

Although the Court found the circuit court erred by granting summary judgment upholding the ordinance as imposing a valid user fee, the Court of Appeals did not reach the questions of whether the fee constitutes a license or a tax. The Court directed the circuit court to consider these questions on remand. However, the Court noted that if the circuit court finds the ordinance imposes a tax, both parties have conceded at oral argument that the tax would be unconstitutional and thus in violation of Kentucky law.

The Fiscal Court filed a petition for rehearing on July 15, 2014 with the Court. The Fiscal Court asserts the Court erred in interpreting the lower court's holding that the 911 fee was a valid user fee pursuant to the user fee statute; rather, the Fiscal Court contends the lower court found it was a lawful fee pursuant to the 911 statute. The Fiscal Court argues that the validity of the 911 fee should be determined pursuant solely to the 911 fee statute (KRS 65.760) without resort to other laws. Further, the Fiscal Court argues the Court erred in determining the previously imposed landline 911 fees are classic user fees and instead are fees pursuant to the authority of the 911 fee statute. Therefore, the Fiscal court argues the Court misapplied state law and argues the 911 fee should be upheld. The petition for rehearing was denied on December 2, 2014.

The Fiscal Court filed a motion for discretionary review with the Kentucky Supreme Court.

The author's law firm represents amicus curiae in this litigation.

4. Occupational License Tax - *City of Corbin and Joe White v. Knox County*, Kentucky Court of Appeals, 2013-CA-000984 and 2013-CA-001090 (May 23, 2014) *motion for disc. rev. denied*, Kentucky Supreme Court, Case No. 2014-SC-330 (February 11, 2015).

The Kentucky Court of Appeals affirmed a ruling of the Knox Circuit Court upholding the constitutionality of KRS 68.197(8), which prescribes the applicability of providing for a credit against the county occupational license tax for a city occupational license tax from March 14, 2012 through July 15, 2014. The provision provides that any credit of city license fees against county license fees existing between a city and county as of March 15, 2012, shall remain in effect as it is on March 15, 2012. This provision also states that the provisions of subsection (7) providing for a credit against the county occupational license tax for a city occupational license tax shall not apply to a city and county unless both the city and county have levied and are collecting license fees on March 15, 2012.

In 1999, the Knox County Fiscal Court established and began collecting an occupational license tax on trades and professions within Knox County. In 2005, the City of Corbin, a city partially situated within Knox County, established a similar license tax. However, the City of Corbin never has attempted to collect its occupational license tax. Therefore, under KRS 68.197(8), the statutory credit would be unavailable to the City's citizens through July 15, 2014.

The City of Corbin and Joe White, a business owner and resident of Corbin and Knox County, sought a declaration that KRS 68.197(8) is unconstitutional. The City and White claimed the provision is unconstitutional because: (1) it was enacted in violation of the title or notice requirement of Section 51 of the Kentucky Constitution; (2) it violates the constitutional prohibition against special legislation set forth in Sections 59 and 60 of the Kentucky Constitution; and (3) it is arbitrary, unreasonable, and discriminatory in violation of Sections 2 and 3 of the Kentucky Constitution.

The Court of Appeals disagreed, finding KRS 68.197(8) is constitutional in all respects. The Court noted that the title or notice requirement requires the title of an act to provide at least "a clue" as to the act's contents in order to prevent surprise or fraud upon the legislature. The Court found this requirement is satisfied with respect to KRS 68.197(8). The Court noted that the bill providing for KRS 68.197(8) was entitled, "AN ACT relating to fiscal matters and declaring an emergency." The Court found credits of city occupational license taxes against county occupational license taxes are logically included within the broad category of "fiscal matters," as "fiscal" generally is understood as relating to public revenue. Therefore, the Court found the title of the act gives fair notice of its provisions and does not violate Section 51 of the Kentucky Constitution.

The Court also found KRS 68.197(8) is not special legislation. The City and White argued the provision constitutes special legislation because it distinguishes between cities that levied and collected occupational license taxes as of March 15, 2012 and those that did not. The Court noted, however, that a legislative classification distinguishing between some cities and counties is constitutional so long as it is based upon some reasonable and natural distinction. The Court found KRS 68.197(8) places a moratorium on new mandatory occupational license tax credits in order to preserve the existing division of occupational license taxes and avoid new and potentially disruptive divisions of revenue during a twenty-eight month period. The Court found that maintaining the status quo during this period of "fiscal turbulence" serves a legitimate legislative purpose.

Finally, the Court found KRS 68.197(8) is not arbitrary because it does not single out a particular entity for special taxation or require a particular entity to bear a heavier burden than other entities. The Court concluded KRS 68.197(8) is rationally related to legitimate state objectives and fully constitutional.

The City of Corbin and Joe White filed a motion for discretionary review at the Kentucky Supreme Court, which has been denied. The opinion of the Court of Appeals is now final.

5. Open Records - Office of the Attorney General, 12-ORD-225, appealed by Mark F. Sommer to the Franklin Circuit Court, *Mark F. Sommer and Tax Analysts v. Department of Revenue*, Case No. 13-CI-29 (August 26, 2014), post-decision motions have been filed by both parties (September 5, 2014) (Pending).

The Franklin Circuit Court recently ruled that the KDOR must produce ruling letters pursuant to the Kentucky Open Records Act. Attorney Mark F. Sommer submitted an Open Records Request to the KDOR in February of 2012 requesting final rulings issued by the KDOR from 2004 to the present. The KDOR denied Mr. Sommer's request, citing KRS 61.878(1) and KRS 131.190(1)(a), which provide that certain tax schedules, returns, or reports filed with the KDOR may not be disclosed if there is an expectation of taxpayer privacy.

Mr. Sommer appealed the KDOR's denial of his request to the Office of the Attorney General. On December 14, 2012, the Attorney General issued 12-ORD-225, affirming the denial of Mr. Sommer's request. The Attorney General relied upon KRS 131.190(1)(a), § 131.081(15), and § 61.878(1)(l), which restrict disclosure of various public records, including certain taxpayer information. In upholding the KDOR's denial, the Attorney General noted, "The sweeping language of Kentucky's statutes relating to disclosure of taxpayer information, as well as the severity of the penalties imposed for unauthorized disclosure, compel us to affirm the agencies' position in this appeal."

Mr. Sommer then appealed to the Franklin Circuit Court. Tax Analysts, a non-profit news organization, sought and was granted leave to intervene in the action after the KDOR denied a nearly identical Open Records Request by Tax Analysts for the same reasons.

The circuit court reversed the Attorney General's ruling and ordered the KDOR to produce the requested information with appropriate redactions. The court found KRS 131.190 and KRS 131.081(15) grant taxpayers the right to privacy with respect to business affairs and returns and reports filed in response to an investigation by the KDOR. However, the court found these statutes "are silent as to information the taxpayer voluntarily submits when appealing the KDOR's ruling on tax liability." The court acknowledged KRS 61.878 exempts certain records of a personal nature from production under the Open Records Act where disclosure would constitute an unwarranted invasion of privacy. Nevertheless, the court noted that "exceptions to disclosure are to be strictly construed in favor of open examination of records" and "[t]he preference for openness and disclosure is an overwhelming trend in the Attorney General's Open Records Decisions."

The court found there "was simply no basis" for the KDOR to deny requests for final rulings that have been appealed to the KBTA. The court noted the KDOR's own administrative regulation provides that all records of proceedings before the KBTA shall be public records. The court found the KDOR's refusal to produce appealed rulings on the basis that it does not keep track of which rulings have been appealed to be incredible. The court stated, "If such minimal records are not maintained by the General Counsel of the Department, this Open Records request will provide a much needed, and apparently long overdue, incentive for the Department's management to identify, and keep track of, the cases [that] have been appealed."

With respect to final rulings that were not appealed, the court found that these rulings, too, were subject to disclosure. The court found KRS 131.190 applies only to information the state compels the taxpayer to produce. According to the court, "[w]hen a taxpayer voluntarily initiates an administrative review of his tax liability and seeks a formal ruling of the Department, the broad rule of confidentiality does not fully apply." Indeed, according to the court, "[t]axpayers who contest their tax liability assessment, proceeding through formal tax administrative adjudication, at least partially waive their rights to confidentiality." The court noted that it had reviewed the final rulings submitted under seal and found "no legitimate basis to keep the vast majority of that information confidential."

B. Trends and Outlooks.

1. New Governor and (Possible) New Commissioner of Department of Revenue.

The Kentucky gubernatorial election will take place on November 3, 2015. Incumbent Governor Steve Beshear is not eligible to run for re-election to a third term due to term limits established by the Kentucky Constitution. With the election of a new governor, a new Commissioner of Revenue may be appointed.

VI. BIOGRAPHIES.

A. Timothy J. Eifler

Timothy J. Eifler is a Member in the Louisville office of Stoll Keenon Ogden PLLC. He serves as Chairperson of the State and Federal Tax Group, and also is a member of the firm's Business Litigation Practice Group. He is involved in all aspects of the firm's tax practice, but has concentrated in complex state and local tax planning, audit defense and federal, state and local tax controversies. A significant portion of Mr. Eifler's practice has also focused on tax-motivated transactional matters and the negotiation and implementation of state and local tax incentives, including corporate income tax credits, wage assessments and sales and use tax and property tax abatements.

In addition to handling matters before the federal, state and local taxing authorities, administrative tribunals and federal and state courts, Mr. Eifler has represented clients before the Kentucky General Assembly on legislative matters through testimony, drafting legislation and preparing comments for legislative hearings. He is AV® Preeminent™ Peer Review Rated by Martindale-Hubbell®, is listed in The Best Lawyers in America® for tax law, and is honored as a Kentucky Super Lawyer for his legal accomplishments in the field of tax law. Mr. Eifler is a member of the Louisville, Kentucky, Indiana, Tennessee, and American Bar Associations. Since 1994, he has been involved with the taxation sections of the Louisville, Kentucky and American Bar Associations. He also finds time to give back to the community by serving on the boards of directors of various nonprofit organizations.

To learn more about Tim visit http://www.skofirm.com/attorneys/timothy-j-eifler.

B. Erica L. Horn

Erica L. Horn serves as Counsel to the Firm in Stoll Keenon Ogden's Lexington office. She is a member of the State & Federal Tax Practice, and represents Kentucky, multistate and multinational companies in matters before the KDOR, the KBTA and the state and federal trial and appellate courts of Kentucky. Erica also represents clients with regard to a wide variety of state taxes including income, sales and use, property and severance.

For her many legal accomplishments, Ms. Horn is AV® Preeminent™ Peer Review Rated by Martindale-Hubbell®, listed in The Best Lawyers in America® in the areas of tax and commercial litigation and is honored as a Kentucky Super Lawyer for tax law. She is a frequent speaker on state and local tax topics. She has spoken across the United States at numerous conferences presented by the ABA Section of Taxation, Council on State Taxation ("COST"), Institute of Professionals in Taxation ("IPT") and others. Since 1985, Erica has been a licensed CPA. She is a practitioner member of COST and a member of IPT, the American, Kentucky and Fayette County Bar Associations, and the Kentucky Society of Certified Public Accountants ("KyCPA").

To learn more about Erica visit http://www.skofirm.com/attorneys/erica-l-horn.

C. Jennifer S. Smart

Jennifer S. Smart is Counsel to the Firm in the Lexington office, and a member of the State and Federal Tax Practice Group. Ms. Smart focuses her practice on handling state and local tax matters for corporate and individual clients across a wide variety of industries. She has experience with administrative proceedings before the KDOR, and has extensive experience in litigation before the KBTA and all levels of the judicial system of Kentucky.

Ms. Smart is AV® Preeminent™ Peer Review Rated by Martindale-Hubbell®. She is listed in The Best Lawyers in America® in the areas of litigation and controversy-tax. She has been recognized as a Kentucky Super Lawyer for several years. Ms. Smart received her J.D. from Tulane University and is a member of the American, Kentucky, Tennessee, Louisiana and Fayette County Bar Associations.

To learn more about Jennifer visit http://www.skofirm.com/attorneys/jennifer-s-smart.

D. Stephen A. Sherman

Mr. Sherman is an Associate in the Louisville office of Stoll Keenon Ogden PLLC and a member of the State and Federal Tax Practice Group. He has been with Stoll Keenon Ogden PLLC since 2008.

Mr. Sherman completed his undergraduate work from the University of Notre Dame and his Juris Doctor from Ave Maria School of Law in Ann Arbor, Michigan. A former President and Secretary of the Federalist Society, Mr. Sherman also served as the Notes Editor for the Ave Maria Law Review. In 2008, he earned his Master of Laws in Taxation from the University of Florida Levin College.

To learn more about Stephen visit http://www.skofirm.com/attorneys/stephen-a-sherman.