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Kentucky Board of Tax Appeals Rules Aluminum Company Required to Include Cost of Raw Materials Owned by Subsidiary for Purposes of Energy Exemptions

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In *Ohio Valley Aluminum Company, LLC v. Dept. of Revenue*, File Nos. K-10-R-35 and K-10-R-36, Order No. K-22086 (May 22, 2012), the Kentucky Board of Tax Appeals (the “KBTA”) held that Ohio Valley Aluminum Company, LLC (“Ohio Valley”) was required to include the cost of raw materials owned by OVACO, its wholly-owned subsidiary, in the cost of production calculation for purposes of the energy exemption from sales and use tax and the utility gross receipts license tax (“UGRLT”). The KBTA found that Ohio Valley’s aluminum casting operation was not separate and distinct from OVACO, which existed on paper only and had no employees. The KBTA determined that Ohio Valley was engaged in only one operation at its plant where it melted raw and scrap aluminum and casted it into billets, and that it was dependent on OVACO for the raw and scrap aluminum which it used. Consequently, the KBTA determined that Ohio Valley had only one plant facility under applicable law and that all costs associated with the production of the aluminum billets should be included in the calculation for purposes of the energy exemptions from both sales and use tax and UGRLT.

Kentucky school districts are authorized to levy up to a 3% UGRLT on the gross receipts derived from furnishing utility services (communications services, electric power, water, and natural, artificial, and mixed gas). Most rural Kentucky school districts levy this tax at the full 3% rate. The Kentucky sales and use taxes are levied at 6% of gross receipts and also apply to the sale of these items and services.

Kentucky’s statutory scheme has an exemption from UGRLT which provides that gross receipts shall not include amounts received for furnishing energy or energy-producing fuels, used by customers in the course of manufacturing, processing, mining, or refining to the extent that the cost of energy or energy-producing fuels used exceeds three percent of the cost of production. *See KRS 160.613(1)*. There is a similar exemption from sales and use taxes. *See KRS 139.480(3)*. Qualifying taxpayers are required to apply for an energy direct pay permit with the Department of Revenue (“DOR”). Taxpayers then pay an estimated tax each month directly to the DOR, rather than to their energy provider. The taxpayer sets forth in the energy direct pay permit application its costs of production and costs related to energy and energy-producing fuels based upon costs incurred in the last completed fiscal or calendar year. *See 103 KAR 30:140*.

The DOR denied Ohio Valley’s application for an energy direct pay permit, and denied the company’s refund claims for overpayments of UGRLT and sales and use taxes. The DOR

based its denial on Ohio Valley's failure to list the cost of raw or scrap aluminum when calculating its costs of production. It was Ohio Valley's position that it was not required to include the cost of the raw aluminum in its cost of production because those materials were owned by its subsidiary, OVACO, and Ohio Valley was merely acting as a "tolling facility" pursuant to a tolling agreement with OVACO. Ohio Valley argued further that the DOR's auditor training manuals provide that under such agreements, parties are not required to include the cost of raw materials in cost of production calculations.

The evidence indicated that the companies had entered a tolling agreement where OVACO owned the raw aluminum and Ohio Valley processed the aluminum into billets for OVACO for a fee. The DOR argued 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 the rest of Ohio Valley's cost and allocated to OVACO.

The KBTA reviewed the decisions in *Louisville Edible Oil Products v. Revenue Cabinet*, 957 S.W. 2d 272 (Ky. App. 1997) and *Revenue Cabinet v. James Beam Distilling Co.*, 798 S.W. 2d 134 (Ky. 1990) and determined that the question before it was whether OVACO's operations were separate and distinct from those of Ohio Valley or whether the Ohio Valley/OVACO operations constituted one plant facility and a single operation. The KBTA determined that in order to meet its burden of proof under *Beam*, Ohio Valley was required to establish that the aluminum casting operation was a truly separate and complete operation from that of OVACO and that Ohio Valley was not dependent on OVACO for the production of its completed aluminum billets.

The KBTA held that the facts were to the contrary - the proof demonstrated that there was not another operation at the plant facility to which raw material costs could be allocated. It noted that OVACO existed on paper only, had no employees and it was actually Ohio Valley that handled all of the bookkeeping and sales transactions with the extrusion customers and the purchasing of raw and scrap aluminum in the name of OVACO.

The KBTA held that as was the case in *Louisville Edible Oil Products*, the evidence indicated that Ohio Valley was engaged in only one operation at the aluminum plant facility and that it melted raw and scrap aluminum and casted the aluminum into billets and was dependent upon OVACO for the raw and scrap aluminum which it used. The KBTA indicated that "the question is not whether Ohio Valley owns the raw and scrap aluminum, but rather, whether the raw and scrap aluminum in question is necessary to that portion of the Ohio Valley operation for which the partial fuel exemption is sought and if it is, it must be included in the facility's cost of production calculation."

The KBTA held that "Even though the taxpayer's wholly owned subsidiary owns the raw materials in question, those raw materials must be included in Ohio Valley's cost of production calculation, because those raw materials are associated with and necessary for the plant operation for which the exemption is sought." The KBTA further held: "all costs associated with the production of these aluminum billets at this plant facility must be included in the calculation for the energy exemption, including the cost of the raw or scrap aluminum which is purchased in its

wholly owned subsidiary's name for use by Ohio Valley at the plant." The KBTA therefore upheld the DOR's Final Ruling letters and denied Ohio Valley's refund claims.

Following the issuance of the KBTA's decision in this case, the DOR has indicated that for purposes of the energy exemption it will continue to recognize legitimate tolling arrangements that have substance and are properly operated. The DOR indicated that its position would change if required by a reviewing court's decision in an appeal of the KBTA's opinion. It is anticipated that Ohio Valley will appeal the KBTA's decision.