COST FALL 2016
Kentucky State and Local Tax Developments

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I. <u>INCOME/FRANCHISE TAXES.</u>

A. Legislative Developments.

1. Internal Revenue Code Conformity Update.

The definition of "Internal Revenue Code" at KRS 141.010(3) was updated to conform to the IRC in effect on December 31, 2015, exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect on December 31, 2015, that would otherwise terminate, and as modified by KRS 141.0101. (2016 House Bill 80.) By operation of law, the update was effective July 15, 2016.

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 (August 14, 2015), *vacated and reversed* (November 10, 2015),

appealed to Kentucky Court of Appeals, Case No. 2015-CA-001852 (Pending).

Last fall, the Franklin Circuit Court granted the Kentucky Department of Revenue's (the "KDOR") motion to alter, amend, or vacate the Court's August 14, 2015 Order holding that an out-of-state corporation and its Kentucky subsidiary were required to file consolidated income tax returns. In so doing, the Court affirmed the final ruling of the KDOR and the Kentucky Board of Tax Appeals (the "KBTA"). The taxpayers, World Acceptance Corporation ("WAC") and its wholly-owned subsidiary, World Finance Corporation of Kentucky ("WFCKY") (collectively "Taxpayers") amended the separate returns initially filed by WFCKY to reflect the consolidated filing of the Taxpayers for tax years 2007-2010. The amended returns resulted in significant refund claims being owed to the Taxpayers, and the KDOR denied the refund claims. Notably, the Taxpayers relied upon a letter ruling issued by the KDOR advising WAC to file a consolidated return.

The Taxpayers appealed the KDOR's denial of their refund claims to the KBTA, which ruled in favor of the KDOR. The Taxpayers appealed the KBTA's decision to the Franklin Circuit Court, which initially reversed the KBTA and ordered the KDOR to grant the Taxpayers' refund claims. In its first order, the Court held the KDOR's interpretation of the relevant statutes contradicted fundamental rules of statutory construction. Nevertheless, the Court granted the KDOR's motion to alter, amend, or vacate the Court's judgment, finding its initial Order was "erroneous".

The KDOR argued the facts contained in the anonymous request for a letter ruling submitted by WAC were materially different from the facts provided in WAC's amended return because WAC failed to disclose that management services were performed outside Kentucky or that the employee providing services in Kentucky also worked in another state. The Court concluded the KBTA's finding that the facts presented in WAC's amended returns were materially different from the facts presented in WAC's request for a letter ruling was based upon substantial evidence. The Court noted that WAC did not disclose that its employee working in Kentucky also worked the majority of the time in other states or that management services were performed outside Kentucky. Furthermore, in a holding that provides unprecedented protections to the KDOR and greatly undermines the utility of the letter ruling process, the Court held:

> [A]n anonymous request for a letter ruling submitted by a taxpayer is not binding on either [the KDOR], the taxpayer, or a Kentucky court of law so long as that request contains facts that are materially different from those submitted in a subsequent filing with [the KDOR] ***or if [the KDOR] misapplies the applicable statutes and regulations to the facts submitted to it by the taxpayer.***

(Emphasis added).

The Court next proceeded to address the parties' statutory construction arguments. Kentucky Revised Statute ("KRS") 141.200(10)(b) requires taxpayers to file separate returns *unless* there is a "common parent corporation doing business in Kentucky" that has nexus with an affiliate. Under KRS 141.200(9)(c), a "common parent corporation" is defined as the member of an “affiliated group” that meets the ownership requirement of paragraph (a)1 or (b)1 of KRS 141.200(9). Because KRS 141.200(9)(a)1 applies to taxable years prior to January 1, 2007, only KRS 141.200(9)(b)1 applied in the instant case. KRS 141.200(9)(b)1 defines an “affiliated group” as “(1) or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if [the common parent owns 80% or more of the stock and value in at least one other includible corporation and 80% of the stock in each of the includible corporations, excluding the common parent, is owned directly by one or more of the other corporations].”

An “includible corporation” is defined as any corporation doing business in Kentucky *unless* the corporation falls within one of the nine exceptions enumerated in KRS 141.200(9)(e). Of relevance here, KRS 141.200(9)(e)7 provides that a corporation is not an includible corporation if the corporation realizes a net operating loss and the corporation’s Kentucky property, payroll and sales factors pursuant to KRS 141.120(8) are de minimis. Similarly, KRS 141.200(9)(e)8 states that a corporation is not an includible corporation if the sum of its property, payroll, and sales factors described in KRS 141.120(8) is zero.

The KDOR argued that under KRS 141.200(9)(b)1, 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. The Taxpayers argued the definition of “includible corporation” applicable to a “common parent corporation” is set forth at KRS 141.200(9)(b), *i.e.*, a common parent corporation is an includible corporation if the ownership requirements set forth in that section are satisfied. Furthermore, the Taxpayers argued that 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), and therefore, this section does not prohibit WAC from meeting the definition of “includible corporation”.

In its final Order, the Court rejected the Taxpayers’ argument that KRS 141.200(9)(b) contains the definition of “includible corporation” applicable to a “common parent corporation”. The Court found KRS 141.200(9)(e) sets forth the definition of “includible corporation” for both “common parent corporations” and other non-parent companies, while KRS 141.200(9)(b) enumerates the ownership requirements for the affiliated group as a whole. The Court reasoned it must presume that when the legislature uses a defined term in a section in which it has already defined the term, the term must mean what is written in its definition and nothing else. The Court also held WAC’s interpretation was contrary to the legislative history of KRS 141.200(9), finding the legislature amended the statute in 2006 to *narrow* the types of common parent corporations that could be part of an affiliated group.

After holding WAC must meet the definition of “includible corporation” in KRS 141.200(9)(e), the Court next found WAC did not meet this definition because WAC fell within the exceptions in either KRS 141.200(9)(e)7 or KRS 141.200(9)(e)8, as its property, payroll, and sales factors were either zero or de minimis.

The Court also summarily dismissed the Taxpayers’ arguments that the KDOR’s denial of their refund claims violated KRS 13A.130, Sections 27 and 28 of the Kentucky Constitution, and the doctrine of contemporaneous construction.

The Court's Order gives short shrift to the standard that must be satisfied for a motion to alter, amend, or vacate to be granted, which the Court acknowledges is "an extraordinary remedy and should be used sparingly."

The Taxpayers have appealed to the Kentucky Court of Appeals, and briefing has been completed.

The authors' firm represents the Taxpayers in this action.

II. <u>TRANSACTIONAL/GROSS RECEIPTS TAXES.</u>

A. Legislative Developments.

1. Sales Tax Exemption for LLCs Owned by Non-Profit Organizations.

The purchases of a company disregarded as an entity pursuant to 26 C.F.R. sec. 301.7701-2 and wholly-owned by a nonprofit educational, charitable, or religious institution which has qualified for exemption from income taxation under Section 501(c)(3) of the Internal Revenue Code are exempt from sales and use tax effective August 1, 2016. (2016 HB 52.)

2. Trading Stamp Regulation Repealed.

Effective August 22, 2016, 103 KAR 28:040 regarding redemption of trading and premium stamps has been repealed because the authorizing statute was previously repealed. The repeal of the regulation was filed effective for the September 15, 2016 filing deadline and will be published in the Administrative Regulation Register for October 2016. The regulation previously interpreted the sales and use tax law as it applies to the redemption of trading or premium stamps for merchandise.

B. Judicial Developments.

1. *Northland Custom Processing, LLC v. Finance & Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, File No. K15-R-15, Final Order No. K-25070 (April 11, 2016), appealed to Franklin Circuit Court, Civil Action No. 16-CI-514 (May 13, 2016) (Pending).

In *Northland Custom Processing*, the KBTA held the KDOR was precluded from re-litigating an issue decided previously by the Kentucky Court of Appeals even though the opinion of the Court of Appeals was unpublished. The case presented to the Court of Appeals, *Northland Corp. v. Revenue Cabinet*, No. 88-CA-27-S (Ky. App. 1988), was referred to as "Northland I". In Northland I the KDOR had denied Northland's qualification for and refund claims related to purchases of energy that should have qualified as exempt from sales and use taxes pursuant to KRS 139.480(3). The "energy exemption" provides that the purchases of energy or energy producing fuels used in manufacturing or processing that exceed 3% of the "cost of production" are exempt from sales and use tax. Generally, the calculation of "cost of production" includes direct costs related to raw materials.

The question in Northland I was whether the lumber used by Northland in a kiln-drying process was direct material that had to be included in the cost of production. The Court of Appeals, affirming the KBTA and Franklin Circuit Court, held that lumber was not a direct material in the process as the operation produced heat, not lumber, and therefore, Northland had properly excluded the costs of the lumber in calculating its energy exemption and in applying for an energy direct pay authorization, which is necessary for claiming the exemption.

The KDOR argued that Northland I should not be applied because *Louisville Edible Oil Products, Inc. v. Revenue Cabinet*, 957 S.W.2d 272 (Ky. App. 1997) ("*LEOP*") constituted a "major change" in the law since the Northland I decision. The KBTA held that *LEOP* was not a major change that would bar the application of collateral estoppel in this case because the case *did not involve the question of whether the lumber was a direct material cost*. Instead, the case held that all direct material costs, including raw materials, had to be included in the cost of production. The KDOR has appealed the KBTA's decision to the Franklin Circuit Court.

2. *City of Florence v. Flanery*, Kentucky Court of Appeals, Case No. 2013-CA-001112 (November 7, 2014) (unpublished), *petition for rehearing denied* (March 13, 2015), *motions for discretionary review granted*, Kentucky Supreme Court, No. 2015-SC-181-D and No. 2015-SC-178-D (February 10, 2016) (Pending).

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. In addition to state officials, the Kentucky CATV Association, Inc., a trade association representing cable television providers, is a defendant in the action.

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. 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, the cities claim the distributed funds do not fully compensate them for their lost tax and franchise fee revenues.

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 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.

Both the state and the Kentucky CATV Association, Inc. filed motions for discretionary review, which the Kentucky Supreme Court granted on February 10, 2016. Oral argument was held on September 15, 2016.

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

3. *Sam's East, Inc. v. Department of Revenue*, Kentucky Board of Tax Appeals, File No. K13-R-21 and *Wal-Mart East v. Department of Revenue*, File No. K13-R-20 (June 27, 2014), Franklin Circuit Court, Civil Action No. 14-CI-00870 (June 9, 2015), appealed to Kentucky Court of Appeals, Case No. 2015-CA-001054 (September 9, 2016).

The Kentucky Court of Appeals recently upheld the constitutionality of a 2009 amendment to KRS 139.570, which retroactively set a cap on the total reimbursement allowed to retailers for collecting and remitting the sales tax. During the period for which the taxpayers claimed refunds (July 2003 to June 2008), KRS 139.570 provided that a seller may deduct on each sales tax return 1% of the tax due in excess of $1,000 as reimbursement for the cost of collecting and remitting the tax. Three budget bills enacted during the refund period placed a $1,500 cap on the total reimbursement allowed per seller in any month. Effective July 1, 2008, the Kentucky General Assembly passed a separate bill (that is, separate from the budget bills) formally amending KRS 139.570 to reflect the $1,500 cap. In 2009, the General Assembly repealed and reenacted KRS 139.570 to include the $1,500 reimbursement limit and apply the limit retroactively from July 1, 2003 to June 30, 2004, and for the period of July 1, 2005 to June 30, 2008.

On average, Petitioners Wal-Mart Stores East, LP ("Wal-Mart") and Sam's East, Inc. ("Sam's") collect and remit a combined $17 million in sales tax each month to the KDOR. 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. On September 8, 2008, Wal-Mart and Sam's submitted refund claims to the KDOR for vendor compensation owed to them over the $1,500 limit. They argued their refund claims were filed after the $1,500 cap provisions in the budget bills expired and within the four year statute of limitations set forth in KRS 134.580.

After the KDOR denied their refund claims, the Petitioners appealed to the KBTA, which affirmed the KDOR's denial and held it did not have jurisdiction to reach the Petitioners' constitutional challenges. The Petitioners appealed to the Franklin Circuit Court, which affirmed.

On appeal, the Kentucky Court of Appeals first held the repeal and reenactment of KRS 139.570 did not violate Section 180 of the Constitution, which provides that every act enacted by the General Assembly levying a tax must specify the purpose for which the tax is levied, and no tax levied and collected for one purpose shall ever be devoted to another purpose. The Petitioners argued that by taking money that was supposed to be collected for reimbursing vendors and redirecting this money to the General Fund, the money was collected for one purpose and devoted to another. The Court disagreed. The Court found that taxes collected by retailers are held in trust for the Commonwealth and thus belong to the Commonwealth (not the retailers) at all times. The Court also held that KRS 139.570 was never intended as a tax purpose statute; instead, it was an allowance or deduction statute that provided the purpose for the deduction, not the purpose for the tax itself. KRS 139.020, however, provides the purpose of the sales tax: to pay off certain state bonds and to provide monies for the General Fund. Thus, the Court found the money was collected for the General Fund all along and not impermissibly transferred.

The Court also rejected the Petitioners' argument that the budget bills violated the provision of Section 51 of the Kentucky Constitution requiring that an act relate to only one subject and that the subject be expressed in the title of the act. The Court held that because the 2009 Act did not violate Section 180, refunds due the Petitioners were constitutionally capped at $1,500. The Court noted that the Petitioners did not appear to argue that the 2009 Act violated Section 51, only that the budget bills violated Section 51. Since the 2009 Act applied the $1,500 cap retroactively throughout the refund period, the Court held it need not address the constitutionality of similar cap provisions contained in the budget bills.

The Court did not determine whether the Petitioners' claims were barred by the statute of limitations, as the circuit court did not address this issue since it found the Petitioners' refund claims were not meritorious, and the Court declined to address an issue on which the circuit court did not have the opportunity to rule.

The Petitioners have thirty days to seek discretionary review by the Kentucky Supreme Court.

4. *Interstate Gas Supply, Inc. for use and benefit of Tri-State Healthcare Laundry, Inc. v. Department of Revenue, Finance and Administration Cabinet*, Kentucky Court of Appeals, Case No. 2013-CA-001766 (February 26, 2016), *motion for discretionary review filed*, Kentucky Supreme Court, No. 2016-SC-000281 (May 31, 2016) (Pending).

A recent decision issued by the Kentucky Court of Appeals held Section 170 of the Kentucky Constitution exempts an institution of purely public charity from the use tax imposed by KRS 139.310. The Court held the use tax imposed by Kentucky statute is similar enough to an *ad valorem* tax to render its enforcement on government entities unconstitutional under Section 170 of the Kentucky Constitution.

The taxpayer, Tri-State Healthcare Laundry, Inc. ("Tri-State") is an institution of purely public charity providing laundry services to several non-profit hospitals in Northern Kentucky. Tri-State purchased all of the natural gas used in its business from Interstate Gas Supply, Inc. ("IGS"), a for-profit corporation headquartered in Ohio. Though a charitable institution, Tri-State is not an IRC § 501(c)(3) organization. Pursuant to KRS 139.340, IGS collected and remitted use tax on the natural gas it sold to Tri-State. Tri-State and IGS then timely filed an application for a refund of the use taxes paid by Tri-State and collected and remitted by IGS on the basis that Tri-State is exempt from use tax under Section 170, which provides, in pertinent part:

> There shall be exempt from taxation public property used for public purposes; . . . real property owned and occupied by, and personal property both tangible and intangible owned by, institutions of religion, institutions of purely public charity, and institutions of education not used or employed for gain by any person or corporation, and the income of which is devoted to the cause of education. . .

The KDOR denied the refund claim, citing *Children's Psychiatric Hospital v. Revenue Cabinet*, 989 S.W.2d 583 (Ky. 1999). In *Children's Psychiatric Hospital*, the Supreme Court of Kentucky held Section 170 does not exempt purely public charities from the hospital provider tax imposed on hospitals and physicians throughout the Commonwealth. The KBTA and the Franklin Circuit Court affirmed the KDOR's denial, holding that under *Children's Psychiatric Hospital*, the exemption set forth in Section 170 is limited to property taxes and does not apply to use taxes.

The Kentucky Court of Appeals reversed. Citing *Commonwealth ex rel. Luckett v. City of Elizabethtown*, 435 S.W.2d 78 (Ky. 1968), the Court stated that under Kentucky law, "the use tax imposed by KRS 139.310 is similar enough to an *ad valorem* tax to render its enforcement on governmental entities unconstitutional under Section 170." The Court distinguished the provider tax at issue in *Children's Psychiatric Hospital*, noting the provider tax is imposed on revenues commonly generated by the rendering of *services* to patients, and not by the acquisition or use of any property. Thus, unlike the use tax, the provider tax does not function in any way similar to a property tax. Finding no indication that *Children's Psychiatric Hospital* explicitly or implicitly overruled *City of Elizabethtown*, the Court held that imposing the use tax on institutions of purely public charity, like Tri-State, violates Section 170 of the Kentucky Constitution.

The KDOR sought a rehearing at the Court of Appeals, which was denied. The KDOR filed a motion for discretionary review with the Kentucky Supreme Court on May 31, 2016.

The authors' firm represents IGS/Tri-State in the action.

5. *Progress Metal Reclamation Company v. Commonwealth of Kentucky, Finance & Administration Cabinet, Department of Revenue*, Kentucky Court of Appeals, Case Nos. 2013-CA-001765 and 2013-CA-001776 (March 13, 2015) (unpublished), *motion for discretionary review denied*, Kentucky Supreme Court, No. 2015-SC-175-D (February 10, 2016).

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. The 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 Kentucky Supreme Court denied Progress Metal's motion for discretionary review, and the decision of the Court of Appeals is now final.

6. *Commonwealth of Kentucky, Finance & Administration Cabinet, Department of Revenue v. Netflix, Inc.*, Kentucky Board of Tax Appeals, File Nos. K13-R-31 and K13-R-32 (September 23, 2015), appealed to Franklin Circuit Court, Civil Action No. 15-CI-01117 (August 21, 2016), appealed to Kentucky Court of Appeals, Case No. 2016-CA-001405 (September 20, 2016) (Pending).

The Franklin Circuit Court recently affirmed the decision of the KBTA holding Netflix's streaming service does not qualify as "multichannel video programming service" ("MVPS") and is not subject to the gross revenues tax and excise tax imposed on MVPS pursuant to KRS 136.616 and KRS 136.604, respectively, and the utility gross receipts license or "school" tax imposed pursuant to KRS 160.614(6). 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).

Netflix's streaming service is a subscription-based service that streams digital movie or television content over the Internet for viewing either on a television or an electronic device. The KDOR argued the streaming service provided by Netflix is generally comparable to the programming provided by a television broadcast station and, therefore, is taxable. In support of its position, the KDOR argued the streaming service offered by Netflix is similar to video on-demand television features available from traditional television providers. The KBTA rejected the KDOR's arguments, finding the statutory definition of MVPS is not broad enough to encompass Netflix's streaming service. The KDOR appealed.

The Franklin Circuit Court affirmed. The Court held Netflix does not provide a MVPS because Netflix's streaming service does not contain content in a multichannel format; indeed, Netflix's service does not include the concept of channels. The Court noted that unlike traditional cable or broadcast television services, Netflix does not offer linear or sequential programming or live content, such as sports, news, weather, or awards shows. Instead, Netflix uses algorithms to preselect content for its customers and allows users to create a personal profile and unique viewing experience.

The Court further held that while Netflix may compete with cable and broadcast television services, this alone is insufficient to subject Netflix's streaming service to tax. The Court stated that it is unreasonable to conclude the legislature intended the statutory definition of MVPS to encompass every possible new technology in the field of transmitting digital content for personal enjoyment. The Court found the KDOR's interpretation of KRS 136.602(8) impermissibly conflated the concepts of competition and comparability.

The KDOR has appealed the Franklin Circuit Court's decision to the Kentucky Court of Appeals.

The authors' firm is co-counsel for Netflix in this action.

7. *Novelis Corporation v. Finance and Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, File Nos. K13-R-35; K14-R-22 (March 24, 2016), appealed to Madison Circuit Court, Civil Action No. 16-CI-00189 (April 22, 2016) (Pending).

The KBTA has held that refractory shapes used at an aluminum processing plant are subject to sales and use tax, rejecting the taxpayer's claim that the shapes are industrial supplies or, alternatively, machinery for new and expanded industry. The taxpayer, Novelis Corporation ("Novelis"), operates a plant in Berea, Kentucky, where it processes aluminum cans and aluminum scrap into ingots that are sent to a sister plant for further processing. The majority of the refractory shapes are used as a protective lining for the room-sized furnaces or aluminum smelters that melt scrap aluminum during the hot metal stage.

Novelis argued the refractory shapes are similar to “fire brick”, which is listed as an industrial supply exempt from sales and use tax pursuant to KRS 139.470(10). The statute exempts certain tangible personal property directly used in manufacturing or industrial processing, if the property has a useful life of less than one year. Repair, replacement, and spare parts, however, are excluded from the exemption. As opposed to industrial supplies, which are intended to be “used up” in the manufacturing process, repair and replacement parts are used to maintain or repair machinery and equipment.

The KBTA found the refractory shapes were an integral part of the large furnaces that melt the molten aluminum. Any item that touches the molten aluminum must be lined with this refractory material, and the refractory items must be purchased each year because they wear and erode. Testimony before the KBTA indicated the shapes are replaced during annual or semi-annual outages at the taxpayer’s plant. Because the shapes wear and erode and are used to mend and repair the furnaces, the KBTA held these items are taxable repair and replacement parts. The KBTA concluded the refractory shapes were distinguishable from fire brick, as the shapes are specially engineered slabs purchased by the taxpayer that are not consumed completely during the manufacturing process, unlike the standard fire brick included in the industrial supplies definition since the 1960s.

The KBTA also held the refractory shapes do not qualify as exempt machinery for new and expanded industry because repair, replacement, and spare parts are excluded from the exemption. Furthermore, the KBTA held the shapes are not exempt from sales and use tax pursuant to KRS 139.480(23), which exempts certain machinery or equipment used primarily for recycling purposes. The KBTA found that when the aluminum enters the hot metal stage of the taxpayer’s operation, the equipment, including the refractory shapes, is primarily being used for manufacturing purposes and not recycling purposes. The KBTA noted the taxpayer can and does receive an income tax credit for some of its recycling equipment, which it uses to transform aluminum cans and scrap aluminum into the raw aluminum product used for its furnaces. Finally, the KBTA rejected the taxpayer’s contemporaneous construction argument, holding the statute at issue was unambiguous.

The taxpayer has appealed the KBTA’s decision to the Madison Circuit Court.

8. *Rent-a-Center East, Inc. and Rent-Way, Inc. v. Finance and Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, File No. K14-R-17 (September 6, 2016).

As most taxpayers are aware, the make-up of the KBTA changed following the election of Governor Matt Bevin last fall. In April, Chairman Marcus Carey and KBTA member Carlo Wessels were appointed to replace former Chairman Cecil Dunn and KBTA member Lindy Karns. KBTA member Jessica Burke was later appointed to replace former KBTA member Lanola Parsons. The “new” KBTA, consisting of Chairman Carey, Mr. Wessels, and Ms. Burke, recently rejected a recommended decision prepared by a former KBTA member acting as a hearing officer. The recommended decision was a holding in favor of the KDOR. Instead, the KBTA found in favor of the taxpayers, Rent-a-Center East, Inc. and Rent-Way, Inc.

The taxpayers are rent-to-own companies that rent and sell household goods, including furniture, appliances, electronics, and computers. To rent or purchase tangible personal property, customers must execute a Rental Purchase Agreement and pay a rental purchase fee. The taxpayers collect and remit sales tax on the rental purchase fee.

The Rental Purchase Agreement provides that customers are liable for the fair market value of the property if it is lost, stolen, damaged, or destroyed. At the time of signing the agreement, customers have the option of purchasing an "Optional Liability Waiver Provision", which covers much of a customer's potential liability for losses. Customers choosing to purchase this coverage pay a separately stated waiver fee in addition to the weekly, semi-monthly, or monthly rental payment. The optional waiver fee is then added to the original Rental Purchase Agreement.

The taxpayers did *not* collect and remit sales tax on optional waiver fees charged to customers for tax years 2007 through 2011. Although the KDOR failed to pick up these waiver fees in prior audits, it concluded the waiver fees were taxable and issued assessments to the taxpayers for the tax years at issue. The KDOR argued the waiver fees were part of the taxpayers' gross receipts from the lease or rental of tangible personal property and thus were subject to Kentucky sales tax.

The taxpayers appealed the assessments issued by the KDOR, arguing the waiver fees were charges for intangible property and therefore not subject to sales tax. The KBTA agreed, rejecting the recommended decision in favor of the KDOR. The KBTA held the optional waiver agreement, for which a separately stated fee is charged, is not tangible personal property as defined by Kentucky law. Indeed, the KBTA noted that the KDOR conceded the waivers at issue were not tangible personal property. Because Kentucky imposes sales tax only on gross receipts derived from retail sales of tangible personal property (and certain select services not at issue in this case), the KBTA held the waiver fees were not subject to tax.

III. PROPERTY TAXES.

A. Legislative Developments.

1. Data Center Exemption.

House Bill 237 was passed by the Kentucky General Assembly, signed into law by the Governor and became effective July 11, 2016. The act amends KRS 91.260 and 92.300 to clarify that qualified data centers constitute manufacturing establishments and therefore qualify for temporary exemption from local property taxes as an inducement to their locating within an applicable city or urban-county, as provided by local ordinance. "Data center" is defined as a structure or portion of a structure predominately used to house and continuously operate computer servers and associated telecommunications, electronic data processing or storage, or other similar components. Qualifying data centers must be established by the owner as having an overall tier rating of 3 or 4 under the TIA-942 Telecommunications Infrastructure Standard for Data Centers. The amendments apply only to new manufacturing establishments locating in an applicable city or urban-county on or after the effective date of the legislation. (2016 HB 237.)

2. Municipal Solid Waste Disposal Facilities.

House Bill 402 was passed into law and signed by the Governor. The bill removes "municipal solid waste disposal facilities", *i.e.*, landfills, from KRS 136.115 and KRS 136.120, which subjected the facilities to tax as public service companies. Beginning with the 2017 tax year, landfills will be subject to property tax in the same manner as other commercial enterprises. The KDOR will retain the sole power to value and assess the real property and improvements of landfills and to bill and collect the associated state property taxes. HB 402 has been codified at KRS 132.202.

Pursuant to KRS 132.202(3)(c), which directs the KDOR to promulgate an administrative regulation to implement a valuation methodology for landfills, the KDOR has promulgated 103 KAR 8:160. Public comments have been submitted, and a hearing is scheduled before the Administrative Regulation Review Subcommittee at 1:00 p.m. on Tuesday, October 11, 2016.

B. Judicial Developments.

1. *Georgetown Partners Ltd. 1 v. Scott County Property Valuation Administrator*, Kentucky Board of Tax Appeals, File No. K15-S-02 (April 13, 2016).

In this case, the KBTA held that when assessing an apartment complex that is subject to federal income and rent restrictions, the restrictions on the complex must be considered by the assessor in the valuation of the apartment complex. The taxpayer presented an appraisal and expert testimony by an MAI appraiser with significant experience appraising low income properties. The appraiser used an income approach to valuation and supported it with the use of comparable sales of similar types of properties in the region.

The appraiser opined that the Property Valuation Administrator ("PVA") overvalued the property by failing to consider that the operating expenses of an income-restricted apartment complex are generally higher than those of a non-restricted property. The PVA acknowledged that his valuation was done using expenses for the property as-if it were a non-restricted apartment complex. The KBTA held that the taxpayer had met its burden of proof and the estimated value set forth in the appraisal was the proper value for the property. Thus, the KBTA reduced the assessment from $2,323,850 to $1,230,000. The PVA did not appeal, and the KBTA's decision is now final.

2. *Union Underwear Company, Inc., d/b/a Fruit of the Loom v. Russell County Property Valuation Administrator*, Kentucky Board of Tax Appeals, File No. 15-S-01 (April 11, 2016), appealed to Russell Circuit Court, Civil Action No. 16-CI-00151 (May 11, 2016) (Pending).

This case involves alleged "omitted property" tax bills issued by the Russell County PVA to the taxpayer for tax years 2009-2014. Kentucky law permits local governments such as counties and cities to issue industrial revenue bonds ("IRBs") to finance certain types of projects, such as manufacturing facilities that will increase employment and other economic activity. The IRB structure reduces a portion of the real and tangible personal property taxes otherwise payable by the taxpayer to local and state government as a result of the existence of the project. Kentucky law provides that real and tangible personal property held by a county or city is exempt from property tax (with the exception of an economically insignificant state leasehold tax). By transferring title in the project to the governmental authority and leasing the project back over a period of years, there is a reduction in the taxpayer's property taxes during the term of the lease. Once the IRBs are paid in full, the taxpayer is subject to property tax at regular state and local tax rates.

In this case, the City of Jamestown issued IRBs in order for the taxpayer to construct a new manufacturing facility. The taxpayer conveyed the real property it purchased from the Russell County Development Association and the manufacturing facility to the city in 1983 and the city leased the property back to the taxpayer. The terms of the lease provided that the lease commenced on the date of the issuance of the bonds and expired on the date the bonds were retired or December 1, 2010, whichever was later. The bonds were paid off and, by its terms, the lease expired in 2000. The city was not notified by the trustee of the bonds, as required, that the bonds had been retired. Thus, while the PVA was assessing the property, the taxpayer continued to receive the statutory exemption from local taxation and the reduced state rate through 2014 when it closed the plant. The PVA is required to assess property even though it is exempt from taxation.

In 2015, the PVA sent a letter to the taxpayer stating "he had deemed the property to be omitted property for the tax years 2009-2014" and the PVA issued "omitted tax bills" based on an assessed value of $24,873,800. Initially, the property was assessed at $4,000,000 and the assessment had increased to $10,000,000 by 2005. While there was no question that the property should have been taxed at full state and local tax rates once the bonds were retired, the question presented was whether the PVA had the statutory authority to issue retroactive tax bills in this circumstance. The KBTA held that the PVA lacked such authority.

The KBTA noted that there are two limited circumstances in which a PVA can amend or send additional bills. Those circumstances include property that was not listed, i.e., omitted property, and instances in which the taxpayer intentionally fails to provide additional information requested in writing by the PVA. The property at issue was not "omitted property" because it was on the tax rolls, and the PVA had not requested information that the taxpayer had failed to provide. As a result, the KBTA held that the PVA lacked the statutory authority to attempt to retroactively assess the property and the tax bills were held to be invalid.

The PVA timely noticed an appeal to the Russell Circuit Court.

3. *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); *motions for discretionary review denied*,

Kentucky Supreme Court, No. 2015-SC-188-D and No. 2015-SC-189-D (December 10, 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, in certain instances, 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 libraries could determine their tax rates using KRS 132.023. As a result of holding in favor of the libraries, 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 filed motions for discretionary review with the Kentucky Supreme Court, which were denied on December 10, 2015. The actions have now been remanded to the circuit court, where the parties completed summary judgment briefing in the *Coleman* case. On September 16, 2016, the Campbell Circuit Court entered an order holding that the decision of the Court of Appeals should be applied prospectively only and, therefore, the library district is not required to refund taxpayers for the excess they paid in ad valorem taxes prior to the rendering of the opinion. The taxpayers have filed a motion to alter, amend, or vacate the Court's Order.

The authors' firm represents the taxpayers in both cases.

4. *Grand Lodge F & A.M. and Springhill Village Retirement Community v. Kenton County PVA and City of Taylor Mill*, Kentucky Board of Tax Appeals, File No. K12-S-69 (November 19, 2014), appealed to Kenton Circuit Court, Civil Action No. 2014-CI-02367 (October 9, 2015), appealed to Kentucky Court of Appeals, Case No. 2015-CA-001617 (Pending).

A Kentucky circuit court has held mere possession of a residential unit in a retirement community constitutes a taxable leasehold interest. The units at issue are part of the "Springhill Village Retirement Community", located on real estate owned by the Grand Lodge of Kentucky, Free & Accepted Masons (the "Grand Lodge") and leased to the Masonic Retirement Village of Taylor Mill, Inc. ("MRV"). MRV owns the improvements to the land, although Grand Lodge retains the right to purchase the improvements from MRV. Both the Grand Lodge and MRV are purely public charities exempt from taxation under Section 170 of the Kentucky Constitution.

The Springhill Retirement Community contains a total of 48 residential units. Each resident enters into a "residential agreement" providing that the resident's interest in the unit is not assignable or transferable, the resident does not obtain title to the unit, and the resident cannot mortgage or encumber the unit. The residential agreement can be terminated under the following circumstances: death, transfer to a nursing home, election of resident to terminate, a determination by MRV that the resident is incapable of continued occupancy, or a resident's refusal to cooperate. Pursuant to the agreement, residents pay an entrance fee between $151,000 and $252,000; 82% of this entrance fee is returned to the resident upon termination. Residents also are responsible for monthly maintenance fees.

Recognizing the Grand Lodge and MRV are tax-exempt entities, the PVA assessed the residential units *to the residents* to whom the units had been leased. The PVA assessed the residents pursuant to KRS 132.195, which provides that when any real or personal property exempt from taxation is leased to "a natural person, association, partnership or corporation in connection with a business conducted for profit", the leasehold is subject to state and local taxation.

The Grand Lodge and individual residents of the community appealed the assessments to the KBTA. The KBTA voided the assessments, holding that both Grand Lodge and MRV were tax-exempt charitable institutions and the use of the property in providing housing for the elderly was within the charitable purpose of MRV.

The Kenton Circuit Court reversed. The Court found that by focusing on the *use* of the property, the KBTA failed to recognize "the separate interests of the residents as part of the 'bundle of rights' encompassed within the total legal interests in the real estate." The Court noted the residents pay an entrance fee for the right to exclusive occupancy and enjoyment of the residential units and also have a right to a refund of 82% of the entrance fee plus a percentage of any increase in value upon resale of the units by MRV. Thus, the Court held the interests of the residents have value and, as such, are subject to property taxes.

The Grand Lodge and individual residents have appealed to the Kentucky Court of Appeals where briefing has been completed.

5. *Chegg, Inc. v. Department of Revenue*, Kentucky Court of Appeals, Case No. 2014-CA-001922 (March 4, 2016), *discretionary review denied*, Kentucky Supreme Court, Case No. 2016-SC-000164 (September 15, 2016).

The Kentucky Court of Appeals ruled in favor of the taxpayer in a case involving the proper construction of an exemption from tangible personal property tax, affirming the circuit court's holding that textbooks stored in a Kentucky warehouse for subsequent shipment out of state are exempt from tax, regardless of whether the books are returned to the state. The taxpayer, Chegg, Inc. ("Chegg"), operates the nation's leading network for online college textbook rentals. In 2010, Chegg opened a warehouse and distribution facility in Bullitt County, Kentucky. During the 2009 and 2010 tax years, Chegg stored textbooks in its Bullitt County warehouse for shipment outside of the state within six months. Specifically, at the beginning of each semester, Chegg rented out a substantial portion of its inventory. When the semester came to a close, these books were returned to Chegg for subsequent rental. Typically, at the end of a twelve to eighteen month cycle, Chegg shipped the books to a third-party seller or wholesale liquidator outside Kentucky for final disposition.

Chegg argued its textbook inventory was exempt from tangible personal property tax under KRS 132.097 and 132.099. KRS 132.097 exempts from state ad valorem tax personal property placed in a warehouse or distribution center for subsequent shipment to an out of state destination. The statute states that personal property shall be deemed to be held for shipment to an out of state destination if the owner can reasonably demonstrate that the personal property will be shipped out of state within the next six months. KRS 132.099 provides a similar exemption from local ad valorem taxes.

The KDOR disagreed, arguing that the word "destination" in the relevant statutes must be construed to mean "final destination." Stated otherwise, the KDOR argued Chegg's textbooks were exempt from tax only if they were held for shipment out of state, never to return to Kentucky again. The KBTA affirmed the KDOR's assessment, and Chegg appealed to the circuit court. The circuit court reversed, holding the plain language of the statutes does not require the personal property to be sent to a "final" or "permanent" destination, just a destination that is outside Kentucky.

The Court of Appeals affirmed. The Court acknowledged that statutes specifying tax exemptions are construed narrowly, but noted that no construction of a statute – narrow or otherwise – can "impinge upon the cardinal rule that a statute is to be construed in accordance with its real intent and meaning and not so strictly as to defeat the legislative purpose." The Court held the KDOR's interpretation of KRS 132.097 and 132.099 impermissibly limits the effect of the statutes by adding a qualification that the "destination" referred to in the statutes be a "final" destination. Citing to Merriam-Webster's Collegiate Dictionary, the Court stated that the plain meaning of "destination" is simply and unambiguously "a place to which one is journeying or to which something is sent." Nothing in this definition denotes or requires permanence. Under the proper construction of the statutes, the Court held Chegg was entitled to the exemptions.

The Kentucky Supreme Court denied review on September 15, 2016, and the Opinion of the Court of Appeals is now final.

6. *Stearns Coal Company v. McCreary County Property Valuation Administrator*, Kentucky Board of Tax Appeals, File No. K12-S-58 (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 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.

7. *Commonwealth v. Petrotek*, Kentucky Court of Appeals, Case No. 2013-CA-001152-MR (June 19, 2015) (not to be published); *motion for discretionary review denied*, Kentucky Supreme Court, No. 2015-SC-000401 (April 27, 2016).

In *Commonwealth v. Petrotek*, the Kentucky Court of Appeals considered the calculation of tax assessments on unmined oil reserves. The appeal concerned taxes levied against four oil wells that pumped a significant amount of oil within the first year (2008) but dried up soon after. KRS 132.820(1) allows the KDOR to value and assess unmined reserves "at no more than fair market value in place, considering all relevant circumstances." Because the General Assembly offered no guidance for determining fair market value of unmined resources, the KDOR developed a formula to estimate the value of unmined resources and then levied taxes accordingly. In the KDOR's formula, the KDOR relied solely on production data from the previous calendar year and refused to consider production data occurring after January 1st in the tax-assessed year.

Because tax bills for the current year were calculated by using data from the prior year, Petrotek received a small tax bill in 2008 based on production numbers from 2007. But in 2009, when production had drastically slowed, Petrotek received a large tax bill based on peak production data from 2008. Petrotek challenged the KDOR's 2009 assessment, arguing that the 2009 assessment violated KRS 132.820(1) because the assessment taxed Petrotek for more than the fair market value of the wells. Petrotek took its case to the KBTA, which considered that post-January 1, 2009 production was much less than the production numbers used to calculate the 2009 tax bill and found that "post-January 1 production data constituted a 'relevant circumstance' within the meaning of KRS 132.820(1), and thus should have been incorporated in the KDOR's assessment for the 2009 year." The Franklin Circuit Court affirmed the KBTA's decision, and the KDOR appealed.

On appeal, the Court considered the amount of deference courts must give to an administrative agency's statutory interpretation. The Court cited the landmark administrative law decision *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984), noting that "[i]f an administrative agency is charged with implementing a statute, and the language of that statute is ambiguous, courts must defer to that agency's interpretation so long as it is reasonable." However, the Court noted that it would defer to an agency interpretation only if the interpretation was an adopted regulation or formal adjudication. Because this case dealt with conflicting interpretations by two agencies with the power to interpret KRS 132.820(1), the KDOR and the KBTA, the Court first considered the threshold issue of whether the agencies' interpretations were regulations or formal adjudications.

The Court determined the KDOR only corresponded with taxpayers in an informal manner and did not issue any regulations. Therefore, the Court did not defer to the KDOR's interpretation because the interpretation did not constitute a regulation or formal adjudication.

The Court found that the KBTA, however, engaged in a formal adjudication, and thus the Court considered whether it must defer to the KBTA's interpretation of KRS 132.820(1) under the *Chevron* framework.

Under the *Chevron* analysis, the first step requires the Court to use ordinary tools of statutory construction to determine whether the General Assembly has "directly spoken to the precise question at issue." If the Court determines the General Assembly has directly spoken, the Court must give effect to the clearly stated intent of the General Assembly. If, however, the General Assembly has not spoken and the statute is silent or ambiguous about the particular issue, the Court proceeds to the second step of the *Chevron* analysis and determines "whether the agency's answer is based on a permissible construction of the statute." If the agency's interpretation is permissible, the Court should generally follow that interpretation.

In applying the *Chevron* framework, the Court concluded it must defer to the KBTA's interpretation of KRS 132.820. First, the Court determined the General Assembly did not specifically address whether post-January 1 production data constituted a "relevant circumstance" within the meaning of the statute. Furthermore, the Court concluded KRS 132.820 was ambiguous because a reader could interpret the term "relevant circumstance" in many different ways. Next, the Court concluded that the KBTA's interpretation of the statute was reasonable by relying on Kentucky cases that define the term "fair cash value" and a case from another jurisdiction that determined the refusal to consider post-January 1 data in valuing an oil and gas lease that suffered a decline in production ignored relevant information. Therefore, the Court concluded that the KBTA's determination of post-January 1 data as relevant was appropriate.

The Kentucky Supreme Court denied the KDOR's motion for discretionary review on April 27, 2016.

8. *Kuhnhein v. Northern Kentucky Area Planning Comm'n and the Northern Kentucky Area Planning Council*, Kentucky Court of Appeals, Case No. 2014-CA-000468-MR (September 11, 2015), *motion for discretionary review denied*, Kentucky Supreme Court, No. 2015-SC-000593 (August 17, 2016).

The Kentucky Court of Appeals granted judgment in favor of the Northern Kentucky Area Planning Commission and Northern Kentucky Area Planning Council (collectively "NKAPC"), finding the collection of ad valorem taxes by the NKAPC was valid because the NKAPC had not been dissolved as provided by statute. The NKAPC was formed in 1961 by adjoining Kenton and Campbell counties in Northern Kentucky pursuant to KRS 147.610, which permits the creation of an area planning commission "[i]n any two (2) or more adjacent counties, one (1) of which has a city having a population of more than 50,000 and not more than 200,000 inhabitants as declared by the last federal census". The City of Covington in Kenton County then had a population of more than 50,000 inhabitants.

Pursuant to KRS 147.660(1), a validly created area planning commission is a political subdivision "in perpetual existence, with power to . . . levy an annual tax" to defray necessary and incidental expenses of the commission. The statute also provides a method for dissolving a commission, and provides that any member county of an area planning commission may withdraw its membership but, the commission would continue to function with the remaining county members.

In 1984, Campbell County withdrew from the NKAPC by following the process outlined by statute, and, in 2008, the City of Covington's population dropped below 50,000. Nevertheless, the NKAPC continued to operate as an area planning commission comprised of Kenton County and various cities within its territory, and the NKAPC continues to assess ad valorem taxes to fund its operations.

This action was filed by Garth Kuhnhein, a resident of Kenton County. Mr. Kuhnhein alleged the assessment and collection of ad valorem taxes by the NKAPC was invalid because the commission no longer meets the requirements of an area planning commission under KRS 147.610. The Kenton Circuit Court granted summary judgment in favor of the NKAPC.

The Kentucky Court of Appeals affirmed. The Court noted the statutory procedures for dissolving the NKAPC had not been successfully followed; therefore, the commission continued to exist. Although the Court noted there may be "some rational logic" to Mr. Kuhnhein's position, it held the statute was clear that the NKAPC could only be dissolved by following the necessary statutory procedures. The Court found that accepting Mr. Kuhnhein's argument "would be repugnant to the constitutional doctrine embodied in Sections 27 and 28 of the Kentucky Constitution [separation of powers]", as the dissolution of an area planning commission is power exercised by the legislative department of the government and may not be exercised by the judiciary.

Mr. Kuhnhein filed a motion for discretionary review with the Kentucky Supreme Court, which was denied on August 17, 2016. The Opinion of the Court of Appeals is now final.

9. *Farmers Nat'l Bank, First State Financial, Inc. and Kentucky Bankers Assoc. v. Commonwealth of Kentucky, Deptartment of Revenue, Michael O'Connell, Jefferson County Attorney, Barbara Holsclaw, Jefferson County Clerk, and John Aubrey, Jefferson County Sheriff*, Kentucky Court of Appeals, Case No. 10-CI-01745 (May 22, 2015), *motion for discretionary review denied*, Kentucky Supreme Court, No. 2015-SC-000326 (April 27, 2016).

In this action, the Kentucky Court of Appeals upheld the constitutionality of Kentucky's delinquent property tax collection system specified in KRS Chapter 134 which allows the sale of delinquent tax certificates to third-party purchasers. Certain statutes within KRS Chapter 134, which provides the statutory framework for collecting ad valorem taxes owed to the State, its counties and their respective tax districts, permit the sale of delinquent tax bills, known as "certificates of delinquency" to private, third party-purchasers. By buying the certificates, the purchasers satisfy the tax debt, and then, in turn, may recoup the cost of the tax certificates and additional fees generated during the collection proceedings from the original taxpayer.

The plaintiff banks and their trade association filed suit in their capacity as mortgage lenders having security interests in parcels of real property subject to ad valorem taxes. The banks alleged the KDOR's sale of tax certificates violated several provisions of the Kentucky Constitution. They also claimed the KDOR violated their due process rights by failing to provide mortgagees the same notice given taxpayers. Various Jefferson County officials intervened as additional defendants in the action.

On November 29, 2012, the Franklin Circuit Court granted the KDOR summary judgment. While noting the sale of tax certificates was susceptible to abuse, the trial court nevertheless determined the legislation was constitutional and that any policy concerns must be resolved by the General Assembly. The banks appealed.

On May 22, 2015, the Kentucky Court of Appeals affirmed. The Court held that the banks had standing because the additional fees charged by third party purchasers had a priority over bank mortgages in foreclosure proceedings. The Court rejected the banks' claim that Sections 181 and 175 of the Kentucky Constitution prohibit the sale of tax certificates to third-party purchasers. The Court found that in selling the certificates, the state neither delegates nor surrenders it authority to impose or collect taxes because the purchasers are not acquiring the right to collect taxes but simply a "chose in action" (a right to record a debt, demand, promissory note or right to recover damages).

The Court also rejected the banks' claim that allowing third-party purchasers to charge additional fees violates the uniformity requirements of Section 171 of the Kentucky Constitution. The Court held that while taxes must be uniform, collection fees do not. Thus, the variance among third-party purchasers as to the amount of fees and the manner by which they are collected does not offend principles of uniformity, nor it is unconstitutionally arbitrary.

The Court rejected the banks' taking claim. Noting federal case law holding that a tax is not a taking under the Fifth Amendment to the U.S. Constitution, the Court held that a tax is not a taking under the Kentucky Constitution (Sections 13 and 242). The Court also held that the failure of the state to give notice to mortgagees of the sale of a tax certificate does not violate due process. While due process requires that property owners receive notice of the sale of a tax certificate, it does not require notice to the mortgagee. Due process does require the mortgagee to receive notice of a foreclosure proceeding pursuant to a tax certificate. Because Kentucky's system requires notice to the mortgagee when a tax certificate is enforced through foreclosure, the Court held the notice requirements of the due process clause are satisfied.

The Kentucky Supreme Court denied the banks' motion for discretionary review on April 27, 2016 and this case is now final.

10. *CPT Louisville I LLC v. Jefferson County Property Valuation Administrator*, Kentucky Board of Tax Appeals, Final Order No. K-24995 (January 8, 2016).

In a recent case involving a real property tax assessment against an upscale shopping center, the KBTA granted a directed verdict in favor of the Jefferson County PVA, holding the taxpayer failed to meet its burden of proving the property was assessed at a value greater than fair cash value.

The property at issue, known as the Paddock Shoppes, is an outdoor shopping mall located in Jefferson County, east of the City of Louisville. In 2014 and 2015, the PVA assessed the property at $111,485,968.58, which was the stated consideration in the deed for the property, filed in May 2013. The taxpayer argued the property should have been valued at only $92,000,000. After the Jefferson County Board of Assessment Appeals upheld the PVA's assessments for both years, the taxpayer appealed to the KBTA.

At the KBTA, the taxpayer presented an appraisal of the property for tax year 2014. In addition, the taxpayer's appraiser testified that the sales price of the property in 2013 was not an accurate indication of the property's fair cash value because the price likely included tangibles and intangibles, such as trained work force, aesthetics, going concern value, and business value. The appraiser testified that he had not reviewed any sales documents to explain or understand the difference between the $92,000,000 value he assigned to the property and the sales price of the property in 2013. Instead, the appraiser used a "residual method", where he appraised the land and buildings and assumed the remainder of the sales price included other tangibles and intangibles.

The KBTA rejected the taxpayer's argument that any intangible component included in the sales price should be excluded from the fair cash value of the property. Citing its decision in *Walgreen Co. and Wilgreen LLC v. Fayette County Property Valuation Administrator*, Final Order No. K-24624 (KBTA March 26, 2014), a decision upheld by the Fayette Circuit Court and the Kentucky Court of Appeals, Case No. 2015-CA-000407, the KBTA concluded that any intangible component enhanced the value of the buildings and land and could not be disregarded in determining the property's fair cash value. Stated otherwise, any added intangible value would be reflected in the 2013 sales price between a willing seller and a willing buyer. The KBTA noted that other states, including Wisconsin and Iowa, also have concluded that intangibles such as "business value" or "transferable income producing capacity" are intertwined with the value of the land and buildings and should be included in the value of the overall property.

Therefore, the KBTA held the 2013 sales price of the shopping mall was the best evidence of the property's fair cash value. Because the taxpayer failed to meet its burden of proving the fair cash value of the property was less than the sales price, the KBTA granted a directed verdict in favor of the PVA. The taxpayer did not appeal the KBTA's decision.

11. *Brandyview Apts., Ltd. v. Madison County Property Valuation Administrator*, Kentucky Board of Tax Appeals, Final Order No. K-25032 (February 25, 2016).

An appraiser valuing a low income apartment complex must consider the restrictions on the property's rental and transfer, the KBTA held recently. The KBTA considered the assessed value of a low income housing tax credit ("LIHTC") complex in Richmond, Kentucky, which consists of a sixteen-unit apartment building and four duplex units subject to the federal LIHTC income and rent restrictions. The Madison County PVA assessed the property at $1,340,000 for the 2014 tax year. The Madison County Board of Assessment Appeals lowered this assessment to $1,040,000, and the PVA assessed the complex at $1,040,000 for the 2015 tax year. The local board upheld the PVA's 2015 assessment. The taxpayer appealed both the 2014 and 2015 assessments to the KBTA, claiming a value of $580,000 for tax year 2014 and $585,000 for tax year 2015.

Each party presented an appraisal in support of its valuation. The PVA's appraisal was based upon the property's value as if it were *not* a low income housing complex with restrictions on its rental and transfer. Thus, the PVA and his appraiser treated the property as a regular free market property, although the PVA's own witness acknowledged that free market properties and LIHTC properties are materially different. The taxpayer's appraiser, by contrast, had significant experience appraising LIHTC properties and valued the property using an income approach. Although he testified that there were not sufficient sales of comparable low income housing projects in the area to enable him to undertake a supporting comparable sales approach, he did testify that he used at least some regional sales of low income housing projects and other non-low income units in order to arrive at his capitalization rate of eight percent. However, he did not present back-up sales information to support his capitalization rate calculation.

The PVA also presented a witness who reviewed the appraisal report submitted by the taxpayer. While the PVA's witness testified he would have preferred to see the back-up sales information supporting the capitalization rate used by the taxpayer's appraiser, he acknowledged he had not conducted an independent appraisal or capitalization rate analysis.

The KBTA held the taxpayer met its burden of proving the PVA's assessment overvalued the property and supported its claimed value with competent evidence from an appraiser with significant experience valuing the type of property at issue. The KBTA stated that restrictions placed on low income housing complexes must be considered by the assessor in the valuation of the property. The KBTA also noted that it had no evidence before it upon which to fix the fair cash value of the property other than the testimony introduced by the taxpayer. Therefore, the KBTA held the property should be valued at $580,000 for tax year 2014 and $585,000 for tax year 2015.

The PVA did not appeal, and the KBTA's decision is final.

12. *Ruby Bennett v. Harlan County Property Valuation Administrator*, Kentucky Board of Tax Appeals, File No. K15-S-39 (February 25, 2016).

The KBTA recently found in favor of a taxpayer from Harlan County, Kentucky, decreasing an assessment of the Harlan County PVA by 50%. At issue was a parcel of commercial property on Central Street in downtown Harlan, valued at $180,000 by the PVA. The taxpayer valued the property at $90,000 and appealed the PVA's assessment to the Harlan County Board of Assessment Appeals, which affirmed the PVA's assessment. The taxpayer appealed the local board's ruling to the KBTA.

Although the taxpayer did not present an appraisal, she offered testimony with respect to the property's condition. Specifically, the taxpayer testified before the KBTA that the three story building on the property had no air conditioning or heating and had not been leased. She also testified that the building had a major roofing problem, which resulted in water damage and required the removal of walls and wiring and led to continuous issues with mold. The walls and wiring had not been replaced as of the assessment date, and the taxpayer testified that the roof continues to leak.

In support of the assessment, the PVA presented information from five sales in downtown Harlan, and a representative from the KDOR offered a cost approach study for the property. However, no adjustments were made to the five sales prices to account for size or condition of the property. Thus, the KBTA found the sales offered by the PVA were not comparable to the subject property. The KBTA also noted that the cost approach did not account for the extensive damage to the building.

Ultimately, the KBTA was persuaded by color pictures of each floor of the property entered into the record by the taxpayer. The pictures showed that the top two floors of the building had no drywall or ceilings, and KBTA found these floors currently were not inhabitable. Although a portion of the first floor appeared to be inhabitable, the KBTA noted that this floor, too, appeared to have been renovated and had obvious mold removed in order to be livable. Based upon this evidence, the KBTA concluded the building could not be compared to other inhabitable buildings in downtown Harlan.

Interestingly, in May 2015, four months after the January 1, 2015 assessment date, the building sold at an absolute auction for $15,000. The KBTA noted that while an appraisal may have shown the building was worth even less than the taxpayer's claimed value of $90,000, the taxpayer was bound by the value claimed in her petition. Thus, the KBTA reversed the final ruling of the local board and directed that the property be assessed at a fair cash value of $90,000.

The PVA did not appeal, and the KBTA's decision is final.

13. *Wilgreens, LLC and Walgreen Co. v. David O'Neill, Fayette County Property Valuation Administrator*, Kentucky Board of Tax Appeals, Final Order No. K-24624 (March 26, 2014), Fayette Circuit Court, Civ. Action No. 14-CI-1566 (February 18, 2015), appealed to Kentucky Court of Appeals, Case No. 2015-CA-000407 (September 23, 2016).

The Kentucky Court of Appeals upheld an assessment of $5,086,000 for tax years 2012 and 2013 on property serving as the location for a Walgreens retail store. The property is situated on Nicholasville Road in Lexington, Kentucky, in a high traffic area surrounded by a residential community and high-end retail. In 2005, the petitioners, Wilgreens, LLC and Walgreen Co. (collectively "Walgreens") entered into an agreement with the owner of the property to construct the building according to Walgreens' specifications. That same year, the owner entered into a triple net lease with Walgreens, wherein Walgreens agreed to pay all real estate taxes on the property. The owner later placed the property for sale and in 2007, the land

and building subject to the lease sold for $6,275,000. The property also was listed for sale in 2013 at a price of $6,900,000.

The Fayette County PVA used the income approach to in arriving at his $5,086,000 value for tax years 2012 and 2013. Walgreens argued the property was worth only $2,600,000, and appealed the PVA's assessments. At the KBTA, both parties presented testimony from three witnesses. Walgreens' certified appraiser valued the property at $2,600,000 by comparing sales of two properties outside of Fayette County and five properties within Fayette County. The properties within Fayette County, however, were in a small strip shopping center and were not located on Nicholasville Road. The KBTA upheld the PVA's value of $5,086,000, noting that the existence of a long-term, build-to-suit lease on commercial property adds measurable value to that property which must be taken into consideration by the PVA when assessing the property. The KBTA found that Walgreens' witnesses either provided no valuation evidence or failed to provide an analysis quantifying the difference in value between the PVA's assessment and Walgreens' proposed value.

The Fayette Circuit Court and the Kentucky Court of Appeals affirmed. The Court of Appeals rejected Walgreens' argument that the PVA overvalued the property by taking into consideration the income generated under Walgreens' triple net lease, which Walgreens asserted was above-the-market. The Court found the PVA's inclusion of this income was consistent with KRS 132.191(2)(b), which provides the PVA may value property using the income approach by estimating the present value of future benefits arising from ownership of the property. The Court also noted that Walgreens attempted to show the property was overvalued by relying on sales of very different properties. Notably, none of the sales relied upon by Walgreens involved properties located on Nicholasville Road or anywhere similar. Indeed, the Court reasoned that the property was capable of generating exactly the kind of income derived under the lease due to its highly desirable location.

Walgreens has thirty days to seek discretionary review from the Kentucky Supreme Court.

14. *Perry County PVA v. Glenn Baker*, File No. K15-S-66 (March 24, 2016); *Perry County PVA v. Glenn Baker*, File No. K15-S-67 (March 24, 2016); *Perry County PVA v. Glenn Baker*, File No. K15-S-68 (March 24, 2016); *Perry County PVA v. Glenn Baker*, File No. K15-S-72 (March 24, 2016); *Perry County PVA v. Daniel Boone Ltd. Partnership*, File No. K15-S-85 (March 24, 2016).

The Perry County PVA's recent attempts to increase property tax assessments in the heart of Kentucky coal country have been rejected by the KBTA. On March 24, 2016, the KBTA issued five orders adjudicating real property appeals from Perry County. With one exception, the KBTA found the PVA failed to present sufficient evidence to support increasing the value of the properties.

Four of the five appeals involved the same taxpayer, Glenn Baker. In *Perry County PVA v. Glenn Baker*, K15-S-66, Final Order No. K-25054 (Mar. 24, 2016), the KBTA upheld the decision of the Perry County Board of Assessment Appeals lowering the value of a parcel of commercial property owned by Mr. Baker from $2,450,000 to $2,100,000. The KBTA noted the PVA failed to present any valuation evidence at the hearing, did not provide an income or sales comparison approach, and did not conduct an appraisal of the property. Although the PVA utilized the sales price in a deed for the property from a 2011 Master Commissioner's sale and from a quitclaim deed the following year, the taxpayer presented evidence at the hearing that neither the 2011 or 2012 deeds represented the fair cash value of the property due to circumstances surrounding each sale. Because the KBTA had no valuation evidence on behalf of the PVA upon which it could base the value of the property, the KBTA affirmed the value set by the local board.

Likewise, in *Perry County PVA v. Glenn Baker*, K15-S-67, Final Order No. K-25055 (Mar. 24, 2016), the KBTA affirmed the local board's ruling valuing an unimproved lot owned by Mr. Baker at $35,000. The PVA valued the lot at $70,000. Although the PVA's representative relied upon the value of three other properties to support the assessment, the KBTA found that unlike the lot at issue, each of the other properties had an improvement. Furthermore, the PVA's witness testified the lot was in the flood zone and therefore could not be improved. The taxpayer testified that he receives no income from the lot, which is used for free parking.

In *Perry County PVA v. Glenn Baker*, K15-S-68, Final Order No. K-25056 (Mar. 24, 2016), the KBTA upheld the local board's value of Mr. Baker's commercial hotel property, which lowered the PVA's assessment from $2,421,000 to $2,000,000. Once again, the KBTA found the PVA failed to present any valuation evidence in support of the assessment. In *Perry County PVA v. Glenn Baker*, K15-S-72, Final Order No. K-25057 (Mar. 24, 2016), the KBTA also affirmed the local board's ruling valuing a motor inn at $850,000, significantly lower than the PVA's assessment of the property at $1,650,000. Although the PVA relied upon assessments of other hotels in the area, the KBTA noted that assessments do not constitute competent probative valuation evidence.

In *Perry County PVA v. Daniel Boone Ltd. Partnership*, K15-S-85, Final Order No. K-25063 (Mar. 24, 2016), the KBTA upheld the PVA's assessment valuing an unimproved, partially paved lot at $700,000, which was based upon the 2006 deed price for the property. The KBTA noted that the taxpayer listed the property for sale at $700,000, and testimony from the PVA's witness indicated the commercial area surrounding the lot was doing well. Thus, the KBTA held the PVA met his burden of proof that the property was worth $700,000 for 2015.

The KBTA's decisions were not appealed and are now final.

IV. OTHER TAXES/EXACTIONS.

A. Legislative Developments.

1. Repealed Regulations – Motor Vehicle Trade-in Allowances and Tax-free Cigarettes.

Effective August 22, 2016, 103 KAR 44:130 regarding motor vehicle trade-in allowances and 103 KAR 41:120 regarding tax-free cigarettes have been repealed because the authorizing statutes previously were repealed. The repeal of the regulations was filed effective for the September 15, 2016 filing deadline, and will be published in the Administrative Regulation Register for October 2016. The motor vehicle trade-in allowance regulation, 103 KAR 44:130, established a method for new vehicle dealers and county clerks to determine the balance of the new motor vehicle credit cap and a process to notify county clerks when the new motor vehicle credit cap was reached. The tax-free cigarette regulation, 103 KAR 41:120, provided a procedure for distribution of tax-free cigarettes in hospitals and other eleemosynary institutions and waived the tax instead of providing refunds of tax previously paid.

B. Judicial Developments.

1. *Saint Joseph Health System, Inc. v. Department of Revenue*, Kentucky Board of Tax Appeals, File No. K12-R-18 (April 30, 2015), appealed to Franklin Circuit Court, Civil Action No. 15-CI-0583 (March 15, 2016).

The Franklin Circuit Court held Saint Joseph Health System, Inc. ("Saint Joseph"), a Kentucky corporation operating several hospitals in the state, is not entitled to refunds of Kentucky's hospital provider tax. The hospital provider tax, imposed pursuant to KRS 142.303, is a 2.5% tax on the gross revenues received by a provider for the provision of hospital services.

Saint Joseph argued federal law expressly prohibits application of Kentucky's hospital provider tax to gross revenues received with respect to payments from the Federal Employees Health Benefits ("FEHB") Fund, CHAMPUS/TRICARE, and Medicare Advantage. Federal statute 5 U.S.C. § 8909(f)(1) provides no state may impose, either directly or indirectly, taxes, fees or other monetary payments on federal carriers with respect to any payment from the FEHB Fund. Pursuant to federal regulations, any state tax on receipts from TRICARE and Medicare Advantage also is prohibited. *See*, 32 C.F.R. §199.17(a)(7)(ii) and (iii) and 42 C.F.R § 422.404.

The Franklin Circuit Court, however, upheld the KDOR's denial of Saint Joseph's refund claims. The Court held federal law does not prohibit taxation of Saint Joseph's receipts because Saint Joseph is a healthcare provider, not an insurance carrier, and the mere possibility that Saint Joseph may pass the costs of the provider tax on to federal carriers was insufficient to preempt application of Kentucky's provider tax to Saint Joseph's receipts.

This case is final.

2. *Revelation Energy, LLC v. Commonwealth of Kentucky, Finance and Administration Cabinet*, *Department of Revenue*, Pike Circuit Court, Civil

Action No. 14-CI-00799 (May 20, 2015), appealed to Kentucky Court of Appeals, Case No. 2015-CA-000930 (Pending).

The taxpayer in this case, Revelation Energy, LLC ("Revelation"), alleged the pre-purchase refund permit requirement set forth in KRS 134.580(8) and KRS 138.345 violates the Due Process Clause and Equal Protection Clause of the United States Constitution and Section 2 of the Kentucky Constitution. KRS 134.580(8) states that "[n]o person shall secure a refund of motor fuels tax under 134.580 unless the person holds an unrevoked refund permit issued by the department before the purchase of gasoline or special fuels and that permit entitles the person to apply for a refund under KRS 138.344 to 138.355." KRS 138.345 states that "[n]o person shall secure a refund of tax under KRS 138.344 unless the person is the holder of an unrevoked refund permit issued by the KDOR before the purchase of the gasoline or special fuel, which permit shall entitle the person to make application for a refund under KRS 138.344 to 138.355."

From October 20, 2009 through January 5, 2011, Revelation purchased significant amounts of special fuel for use in unlicensed vehicles and equipment for nonhighway purposes related to its coal mining operations in Kentucky. Revelation purchased the fuel from licensed Kentucky dealers, who charged Revelation the special fuel tax imposed by KRS 138.220 and the petroleum environmental assurance fee imposed by KRS 224.60-145. Until the beginning of 2011, Revelation was unaware its nonhighway use of the special fuel meant its purchases were exempt from the special fuel tax and the petroleum environmental assurance fee.

Once Revelation became aware it had been paying special fuel tax and the petroleum environmental assurance fee on its special fuel purchases in error, Revelation applied for a Kentucky motor fuels tax refund permit with the KDOR. The KDOR granted Revelation's application and issued a permit with an effective date of January 6, 2011. In October 2011, Revelation submitted refund applications to the KDOR for refund of the special fuel taxes and petroleum environmental assurance fees it mistakenly paid during the calendar years ending December 31, 2009 through December 31, 2011. Revelation's refund applications were filed within the four year statute of limitations imposed by KRS 134.590.

The KDOR granted Revelation's refund claim for taxes and fees paid on purchases of special fuel *after* the January 6, 2011 effective date of Revelation's motor fuels tax refund permit. However, the KDOR denied Revelation's refund claim for $968,182.18 in special fuel taxes and $65,546.28 in petroleum environmental assurance fees Revelation paid on its purchase of special fuel for non-highway purposes made between October 20, 2009 and January 5, 2011, alleging Revelation did not meet the pre-purchase refund permit requirement set forth in KRS 134.580(8) and KRS 138.345.

Revelation protested the KDOR's denial of its refund claim, alleging the pre-purchase refund permit requirement is unconstitutional. The KDOR issued a Final Ruling denying Revelation's claim, and Revelation appealed to the KBTA. The KBTA upheld the KDOR's Final Ruling, finding it did not have jurisdiction to rule on Revelation's challenge to the facial constitutionality of the pre-purchase refund permit requirement under KRS 134.580(8) and KRS 138.345.

Revelation appealed the KBTA's order to the Pike Circuit Court. In a lengthy opinion, the Court held the pre-purchase refund permit requirement in KRS 134.580(8) and KRS 138.345 violates the Due Process Clause of the United States Constitution. The Court noted the Due Process Clause requires states to provide sufficient procedural safeguards against erroneous or unlawful exactions of tax. In order to satisfy this standard, the government must provide taxpayers with either: (1) a pre-deprivation remedy, which allows the taxpayer to withhold the tax and dispute the amount owed; (2) a post-deprivation remedy, which allows the taxpayer to challenge the amount paid and obtain a refund of taxes wrongfully collected; or (3) a combination of both a pre-deprivation remedy and a post-deprivation remedy that allows the taxpayer to challenge its correct tax liability.

The Court found that, where applicable, KRS 134.580 generally satisfies this standard by providing Kentucky taxpayers with the right to challenge a Kentucky tax they believe was erroneously paid or wrongfully collected, and to obtain a refund if their challenge is successful. However, the Court noted, when a taxpayer erroneously pays motor fuels tax on the purchase of non-highway special fuel, the pre-purchase refund permit requirement restricts the taxpayer's right to pursue a refund claim under KRS 134.580 to only those taxes paid after the taxpayer secured a motor fuel refund permit from the KDOR. Thus, the refund permit requirement effectively eliminates any meaningful post-deprivation remedy provided by KRS 134.580 for taxpayers like Revelation who discover they have mistakenly overpaid fuel taxes and are left with no recourse to recover the overpayment. The Court noted it was unaware of any other state tax for which the taxpayer's general refund rights for the overpayment of taxes are similarly restricted.

Importantly, the Court found the Supreme Court's decision in *McKesson Corporation v. Division of AB&T*, 496 U.S. 18 (1990) – where the Court outlined guidance regarding the protections a state must provide in the context of tax refund procedures in order to satisfy the requirements of due process – was not limited to unconstitutional taxes. The Court also distinguished the pre-purchase refund permit requirement from permissible procedural refund requirements, such as a statute of limitations period for claiming a refund. The Court noted that a statute of limitations period typically begins to run upon the occurrence of an identifiable event, such as the filing of a tax return or the payment of tax. The taxpayer then has a reasonable period of time in which to uncover any error and seek a refund. In addition, statutes of limitation provide a balance in that a reasonable limitations period protects the state's interest in financial stability by not having to account for an indefinite number of refund claims. Unlike a reasonable statute of limitations, however, the pre-purchase refund permit requirement provides no room for taxpayer error and eviscerates a taxpayer's remedy where the taxpayer erroneously pays tax without first seeking a permit.

The KDOR has appealed the Pike Circuit Court's Opinion and Order to the Kentucky Court of Appeals. The case has been submitted for a decision without oral argument.

3. *Owensboro Grain Co., LLC v. Finance and Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, Final Order No. K-25051 (February 25, 2016).

The KBTA has held that fuel purchased and loaded into tank cars in Kentucky for immediate shipment out-of-state is not subject to the special fuels tax and petroleum environmental assurance fee. The taxpayer, Owensboro Grain Company, produces a wide variety of products from soybeans. In 2007, the taxpayer opened a biodiesel fuel production facility to produce its B100 renewable biodiesel fuel, which blends vegetable oils with diesel fuel to create cleaner fuel that substantially reduces carbon emissions. The manufacture of the B100 biodiesel fuel occurs at the taxpayer's plant locations in Western Kentucky.

During the period at issue, the taxpayer sold some of its biodiesel fuel to out-of-state purchasers. Under the terms of the taxpayer's sales contracts, the fuel was sold FOB-Owensboro, Kentucky, and the purchasers made their own arrangements for shipping the fuel out-of-state. In each instance, the fuel was loaded into the carrier's tank car or tank truck in Kentucky and then shipped directly to the purchaser's out-of-state location.

The KDOR argued that although the fuel was exported to out-of-state customers, the fuel was actually "received in this state" and subject to the special fuels tax and petroleum environmental assurance fee. Under KRS 138.220(1)(a), an excise tax is imposed on all gasoline and special fuel "received in this state" at the rate of nine percent (9%). Likewise, under KRS 224.60-145(1), a petroleum environmental assurance fee is imposed on dealers on each gallon of gasoline and special fuels "received in this state."

The KBTA rejected the KDOR's position, noting it needed to look no further than the plain meaning of the word "received" in the definitional statute, KRS 138.210(15). The statute defines "received" or "received gasoline" or "received special fuels" to mean the following:

> Gasoline and special fuels . . . shall be deemed to be **received when it has been loaded for bulk delivery into tank cars or tank trucks consigned to destinations** within this state. . . . **[I]t shall be presumed that all gasoline and special fuel loaded by any licensed dealer within this state into tank cars or tank trucks is consigned to destinations within this state, unless the contrary is established by the dealer. . . .**

(Emphasis Added). In other words, the KBTA noted, all the statute requires is a showing by the dealer that the fuel loaded in Kentucky is consigned to a destination outside this state. It does not matter that the dealer arranged for pick-up of the fuel in Kentucky or that the terms of delivery were FOB Kentucky. If the legislature intended for the FOB-designation to control taxation of the fuel, it could have so specified. Furthermore, although the taxpayer did not raise a constitutional issue, the KBTA noted imposition of tax on fuels used outside of Kentucky constitutes a constitutionally forbidden burden on interstate commerce.

The KDOR did not appeal, and the KBTA's decision is final.

4. *Estate of Mildred L. McVey v. Department of Revenue*, Kentucky Supreme Court, 480 S.W.3d 233 (Ky. 2015).

In a recent case involving Kentucky's inheritance tax, the Supreme Court of Kentucky held a reviewing court does not owe any deference to the KBTA as to questions of law. The case involved whether inheritance taxes paid as a "cost of administration" under a will's tax exoneration provision may be deducted from the value of distributive shares under KRS 140.090 and thereby reduce the overall tax liability, and whether the payment of tax by an estate on behalf of a beneficiary is itself a taxable "bequest of tax".

The KBTA held that inheritance taxes paid by the estate under a tax exoneration provision are deductible under KRS 140.090 where the decedent's will directs that such taxes shall be paid as "costs of administration". The KBTA also held that a bequest of tax is not a taxable transaction. The Franklin Circuit Court reversed, reviewing the KBTA's decision *de novo*, and the Court of Appeals affirmed. The Supreme Court of Kentucky granted discretionary review.

The Court held the KBTA's interpretation of the statutes at issue was not entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837(1984). The Court first noted that so-called "*Chevron* deference" applies only where a statute is silent or ambiguous with respect to the specific issue before the court. Because the statutes involved were neither, the Court found no deference should be given to the KBTA's interpretation.

More importantly, the Court noted that deference is given only to an administrative agency's interpretation of a statute *which it administers*. The KBTA is an administrative *review* agency that determines appeals of tax rulings. Thus, the Court stated, the KBTA does not administer Kentucky's inheritance tax statutes or any other portion of the Kentucky statutes. Instead, the statutes are administered by the KDOR. According to the Court, if any deference is to be given, it is to the KDOR's formal interpretation of statute it administers. Therefore, the Court held a reviewing court's review of a decision by the KBTA is *de novo*, and no deference is to be given to the KBTA's interpretation of tax statutes.

The Court also held that inheritance taxes paid by an estate are not deductible from the value of the gross estate under KRS 140.090, because they do not fall within the deductions listed in the statute. Furthermore, the Court held that taxes paid by an estate on behalf of a beneficiary – "bequests of tax" – are taxable transactions. The Court reasoned that when a beneficiary receives the benefit of tax paid on his or her behalf, the tax paid is itself a taxable transfer of property and is part of the overall bequest; therefore, it is subject to inheritance tax. Interestingly, the Court found the KDOR's attempted correction of the estate's inheritance tax return was incorrect and resulted in an *under*statement of the tax due. However, because the KDOR sought a judgment in the amount of tax it had assessed, the Court found the KDOR was not entitled to recover the additional tax.

5. *Greater Cincinnati/Northern Kentucky Apartment Ass'n, Inc. v. Campbell County Fiscal Court*, Kentucky Supreme Court, 479 S.W.3d 603 (Ky. 2015), *petition for rehearing denied* (February 18, 2016).

The Supreme Court of Kentucky has held the fee imposed by the Campbell County Fiscal Court to fund 911 emergency telephone service is constitutional and a valid exercise of the County's statutory authority. Historically, emergency 911 service in Campbell County, like much of Kentucky, was funded by a monthly subscriber fee on landline telephones. Due to the recent decrease in landline phones, the landline fee has become an inadequate source of revenue. On August 7, 2013, the Fiscal Court adopted Ordinance O-04-13, which replaced the landline fee with an annual service fee of $45 on each occupied individual residential and commercial unit in Campbell County. The 911 fee is placed on the property tax bills of property owners in the County.

Shortly after the Fiscal Court adopted the Ordinance, the Greater Cincinnati/Northern Kentucky Apartment Association and other commercial and residential property owners in Campbell County (collectively, the "Association") filed a declaratory judgment action alleging the Ordinance was unconstitutional and in contravention of the Kentucky statutes. The Circuit Court ruled in favor of the County, and the Association appealed. Due to the statewide importance of the case, the action was transferred from the Court of Appeals directly to the Kentucky Supreme Court.

The relevant statute is KRS 65.760(3), which provides, in pertinent part, "The funds required by a city, county, or urban-county government to establish and operate 911 emergency telephone service . . . may be obtained through the levy of any special tax, license, or fee not in conflict with the Constitution and statutes of this state." The County conceded the 911 fee is not a valid tax or license, but claimed the fee is a valid *user* fee. The Association countered that the 911 fee is an impermissible user fee because the fee is not based upon actual *use* as required by KRS 91A.510, which defines a "user fee" as a "fee or charge imposed by a local government on the *user* of a public service for the *use* of any particular service not also available from a nongovernmental provider." (Emphasis Added). The Association argued that property owners required to pay the 911 fee may never dial 911 and, thus, there is no correlation between the 911 fee and the benefit received, as required by Kentucky law.

Despite the County's argument that the 911 fee is a valid user fee, the Court found the "fee" authorized by KRS 65.760(3) need *not* be a user fee. The Court noted that KRS 65.760 does not refer to KRS 91A.510 or qualify the term "fee". Therefore, the Court set up a "new" test for the "fee" authorized by KRS 65.760(3), holding the fee "must bear some relationship to the benefit received." The Court found this test was satisfied with respect to the 911 fee because "911 emergency telephone service derives significantly from residents' occupation and use of [their] properties." The Court further stated:

> While the scope of benefits received from the 911 emergency telephone service is incapable of precise measure, it is uncontroverted that all citizens benefit from that service. . . . To assess payment upon only those citizens actually telephoning 911 is not, nor has it ever been, the policy of our counties or our Commonwealth.

In a vigorous dissent, Justice Venters, joined by Chief Justice Minton, analogized the majority's attempt to fit the 911 fee into the current statutory framework to driving a square peg into a round hole. The dissent noted the 911 fee fits within none of the criteria required for a valid governmental fee and bears all the hallmarks of a tax. Fees properly assessed by governmental entities, the dissent reasoned, must be either regulatory or license fees or user fees. Because the 911 fee does not regulate a profession or activity, it does not fall within the first category of fees. Moreover, the 911 fee is not a valid user fee because there is no relationship between the fee charged and the benefit received. In fact, the dissent noted, the County conceded that *all* citizens benefit from 911 service regardless of whether they own property and pay the fee. Because the 911 fee is not a regulatory fee or a user fee, the dissent found the fee is exactly what it appears to be: a tax. And because the "fee" is a flat tax on property and is not imposed on an ad valorem basis, it violates Section 174 of the Kentucky Constitution.

The Association's petition for rehearing was denied, and the Court's opinion is now final.

The authors' firm represented the Association in this action.

6. *City of Lancaster v. Garrard County*, Kentucky Court of Appeals, Case No. 2013-CA-000716-MR (July 3, 2014), *petition for rehearing denied* (December 2, 2014), *motion for discretionary review granted and case remanded to Court of Appeals,* No. 2014-SC-000738-D (February 18, 2016) (Pending.).

The Kentucky Supreme Court recently granted discretionary review in *City of Lancaster v. Garrard County* for the purpose of vacating the opinion of the Kentucky Court of Appeals. The Court remanded the case to the Court of Appeals for further consideration in light of its decision in *Greater Cincinnati/Northern Kentucky Apartment Association, Inc. v. Campbell County Fiscal Court*, which upheld a 911 fee on each occupied individual residential and commercial unit in Campbell County. In *City of Lancaster*, the Kentucky Court of Appeals reversed and remanded a decision of the Garrard Circuit Court upholding Garrard County's 911 fee as a valid user fee. 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 and 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.

After its petition for rehearing was denied, the Fiscal Court filed a motion for discretionary review with the Kentucky Supreme Court. As noted, the Court granted the Fiscal Court's motion and remanded the case to the Court of Appeals for further consideration in light of the Court's decision in *Greater Cincinnati/Northern Kentucky Apartment Association, Inc. v. Campbell County Fiscal Court*. The case is now once again under submission to the Court of Appeals for a new opinion.

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

7. State 911 funding - *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), *remanded and final judgment entered*, Jeff. Cir. Ct. No. 2015-CA-001312 (July 29, 2015), appealed to Kentucky Court of Appeals, Case No. 2015-CA-001312 (Pending).

In this case, Virgin Mobile USA, LP ("Virgin Mobile") challenged the imposition of the CMRS service charge imposed under KRS 65.7629 prior to July 2006. Virgin Mobile remitted the CMRS service charge to the 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.

Jefferson Circuit Court. 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.

Ky. Court of Appeals. 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 Virgin Mobile was required to collect the charges in question, the issue of whether Virgin Mobile was entitled to a refund or credit was moot, and the court declined to address the issue further.

Ky. Supreme Court. 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.

Jefferson Circuit Court – remand. On remand, Virgin Mobile sought to pursue its claim for refund. Virgin Mobile filed a CR 67 motion with the Jefferson Circuit Court seeking to deposit into court the amount of post-July 2006 CMRS charges determined to be owed (the amount of the "credit" taken). The trial court denied Virgin Mobile's motion based on the law of the case doctrine and held that Virgin's refund claim had been adjudicated. The trial court entered its final judgment. Virgin Mobile satisfied the judgment and has appealed the issue of whether it is entitled to a refund of the pre-July 2006 CMRS charges it mistakenly paid.

The authors' firm represents Virgin Mobile in this action.

8. *T-Mobile South LLC v. Kentucky Commercial Mobile Radio Serv. Emer. Telecommunications Bd.*, Kentucky Board of Tax Appeals, File No. K09-R-24 (Sept. 23, 2015), appealed to Franklin Circuit Court, Civil Action No. 15-CI-01124 (Pending).

The KBTA recently held it lacked jurisdiction over disputes concerning the State's emergency 911 fund. The fund is operated and maintained by the Commercial Mobile Radio Service ("CMRS") Board. In this case, the petitioner, T-Mobile, appealed a ruling issued by the CMRS Board denying T-Mobile's claim for a refund of service charges it had remitted. The case was held in abeyance pending final resolution of *Virgin Mobile U.S.A., L.P. v. Commonwealth of Kentucky*, 2012-SC-000621-DG & 2012-SC-00626-DG (Ky. Dec. 18, 2014) (to be published), which addressed the same substantive issue, *i.e.*, the collection of the service charge by wireless prepaid phone providers. The CMRS Board moved for dismissal based on lack of jurisdiction. The motion to dismiss initially was denied by the KBTA without explanation, but the issue was revisited when new members of the KBTA took office.

The KBTA's jurisdictional statute, KRS 131.340, empowers it to hear final rulings "of any agency of state government affecting revenue and taxation". The issue presented was whether the KBTA had jurisdiction to hear an appeal in which the petitioner sought a refund of the 911 service charge. Pursuant to statute, the CMRS Board collects the 911 service charge from wireless providers to implement and maintain an enhanced wireless 911 service. The service charge goes into the "CMRS fund".

The parties' arguments centered upon whether the service charge is a "fee" or a "tax". Unlike taxes, fees must bear a relationship to the cost of administering the regulatory program. T-Mobile argued the service charge is a tax because the amounts collected from the service charge exceed those expended in administration and enforcement of the CMRS statutes. However, the CMRS Board argued, and the KBTA agreed, that the statute governing the service charge – KRS 65.7631 – clearly provides that all funds collected are used to establish and improve emergency 911 services. T-Mobile also claimed the service charge was paid directly to the Kentucky State Treasurer, and this direct payment made the charge a tax, although information at oral argument revealed the money was then transferred from the General Fund to the CMRS fund. The KBTA found that whether money was initially deposited into the state treasury or a special fund was not dispositive of whether the charge was a "fee" or "tax". Because it found the service charge was a fee over which it had no jurisdiction, the KBTA dismissed T-Mobile's appeal.

T-Mobile has appealed the KBTA's decision to the Franklin Circuit Court.

9. *Telrite Corporation (d/b/a Life Wireless) v. Commercial Mobile Radio Service Emergency Telecommunications Board of Kentucky*, Franklin Circuit Court, Civil Action No. 15-CI-00886 (August 12, 2015) (Pending).

In this action, Telrite Corporation is seeking a refund of state 911 fees mistakenly remitted on wireless phone services provided at no charge to qualifying low-income Kentucky consumers under the federal Lifeline Program. Telrite is seeking a declaration that: (1) Telrite has no duty to collect or remit state 911 fees relative to its Lifeline customers who make no payment for services provided to them; and (2) Telrite is entitled to a refund of amounts mistakenly paid from Telrite's own funds with respect to such customers for the periods July 2013 through September 2014. Telrite is further seeking an order requiring the CMRS Board to issue the refunds. Summary judgment briefing is underway.

The authors' law firm represents Telrite in this litigation.

V. OTHER NOTES OF INTEREST.

A. Legislative Developments.

1. Tax Forms and Instructions.

Senate Bill 129, passed by the General Assembly and signed by the Governor, creates a new section of KRS Chapter 141 to require the KDOR to publish tax forms and instructions to those forms without promulgation of an administrative regulation, and amends KRS 13A.110, 131.130, 141.050 and 141.068 to conform. (2016 Senate Bill 129.)

2. Division of Taxpayer Ombudsman.

Senate Bill 293, passed by the General Assembly and signed by the Governor, amends KRS 131.020 to create a "Division of Taxpayer Ombudsman". Previously, the statute simply provided for a "taxpayer ombudsman". This statutory change is consistent with the KDOR's recent action to create a position for a taxpayer liaison. It appears the liaison will be part of the Division of Taxpayer Ombudsman as the liaison has been working with the ombudsman. The Division Director will report directly to the Commissioner of the KDOR. (2016 Senate Bill 293.)

B. Judicial Developments.

1. 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), denial of KDOR's motion for reconsideration (June 25, 2015), Kentucky Court of Appeals, Case No. 2015-CA-001128 (Pending).

Last year, the Franklin Circuit Court denied a motion for reconsideration filed by the KDOR and upheld an award of attorneys' fees to Petitioners Mark F. Sommer and Tax Analysts, awarding over $30,000 in attorneys' fees based upon the KDOR's "willful refusal" to produce appealed final rulings under the Kentucky Open Records Act.

Attorney Mark F. Sommer submitted an Open Records Request to the KDOR in 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 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. 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 filed by the news organization.

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 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 noted that "exceptions to disclosure are to be strictly construed in favor of open examination of records."

The Court held there "was simply no basis" for the KDOR to deny requests for final rulings appealed to the KBTA, as the KDOR's own administrative regulation acknowledges that all records of proceedings before the KBTA shall be public records. With respect to final rulings that were ***not*** appealed, the Court found that these rulings, too, were subject to disclosure. The Court said KRS 131.190 applies only to information the state compels the taxpayer to produce and not when a taxpayer voluntarily initiates an administrative review of his tax liability and seeks a formal ruling of the KDOR.

Because the Court found the KDOR's withholding of *unappealed* final rulings was not willful, the Court denied Mr. Sommer's request for fees and penalties on that issue. However, the Court granted Mr. Sommer's request for fees and penalties under KRS 61.882(5) to the extent the requests sought disclosure of final rulings appealed to the KBTA.

The KDOR filed a motion asking the court to reconsider the Court's ruling, which the Court denied on June 25, 2015. The KDOR argued its failure to produce final rulings was not willful because it was based upon a good faith determination that producing the documents was unduly burdensome under KRS 61.872(6). In the alternative, the KDOR argued the requested attorneys' fees should be significantly reduced because the fees were not limited to work spent on appealed final rulings and did not reflect a local market rate.

The Court noted that under KRS 61.882(5), "any person who prevails against an agency in any action in the courts regarding a violation of KRS 61.870 to 61.884 may, upon a finding that the records were willfully withheld in violation of KRS 61.870 to 61.884, be awarded costs, including reasonable attorney's fees, incurred in connection with the legal action." The Court found Mr. Sommer and Tax Analysts were entitled to reasonable attorneys' fees in connection with their requests for final rulings appealed to the KBTA because such rulings are a matter of public record. The Court was not persuaded by the KDOR's argument that production of the appealed final rulings was unduly burdensome. The Court found the KDOR's blanket denial of the Open Records request was a "willful" violation of the Act and justified an award of attorneys' fees. The Court also found the fees at issue were reasonable and within the prevailing market rates for the services performed. The Court awarded half of the requested attorneys' fees and costs (based upon its determination that fees and costs were not warranted with respect to KDOR's failure to produce *unappealed* final rulings), which amounted to a total award of \$30,467.59 (\$24,432.94 to Mr. Sommer and \$6,034.65 to the Tax Analysts). The Court, however, found statutory penalties were not warranted.

The KDOR has appealed the Court's Order to the Kentucky Court of Appeals. Oral argument was held on September 20, 2016.

2. Open Records - *Pike County Fiscal Court v. Utility Management Group, LLC*, Kentucky Court of Appeals, Case No. 2013-CA-000929-MR (June 12, 2015) (to be published), *petition for rehearing denied* (November 2, 2015), *motion for discretionary review granted*, Kentucky Supreme Court, No. 2015-SC-680-D (Pending).

In *Pike County Fiscal Court v. Utility Management Group, LLC*, the Kentucky Court of Appeals considered whether a change to Kentucky's Open Records Act ("ORA") was merely a clarification—and thus would apply retroactively—or a substantive change to the law. At issue in this case was whether Utility Management Group, LLC ("UMG") qualified as a public agency subject to the disclosure requirements of the ORA. Notably, UMG provided water, sewer, garbage, and other services to the City of Pikeville and a Pike County Water District through publicly bid contracts. Pike County sent an open records request to UMG seeking copies of UMG's "checks and expenses."

At the time of the request, KRS 61.970(1)(h) treated as public agencies subject to the ORA "any body which derives at least twenty-five percent (25%) of its funds ... from state or local authority funds." UMG denied the request, claiming UMG constituted a "wholly private entity" not subject to the ORA. Pike County requested the Office of the Attorney General ("OAG") review UMG's refusal to comply with the ORA request, and the OAG determined that

UMG fell within KRS 61.970(1)(h) and should comply with Pike County's request. UMG then challenged the OAG's decision in Pike Circuit Court. Before the circuit court could rule, the Kentucky General Assembly amended the ORA to exempt from the 25% calculation public funds received as compensation for goods and services provided by a publicly bid contract. The circuit court treated the amendment as a "remedial clarification" that applied to all pending suits and thus held that UMG fell within the exception and was not a public agency subject to the ORA.

However, the Kentucky Court of Appeals disagreed and held that the amendment to KRS 61.970 represented a substantive instead of remedial change in the law, and therefore did not apply retroactively. In reaching this decision, the Court first noted that Kentucky statutes do not apply retroactively unless the statute explicitly provides for retroactivity. Finding no express statement of retroactivity, the Court next stated, "[S]tatutory amendments that seek only to clarify, not substantively change, existing law are remedial in nature." These remedial amendments apply retroactively even absent an express statement of retroactivity.

Kentucky has not adopted a specific test to determine whether an amendment clarifies or substantively changes a statute. Therefore, the court examined law from other jurisdictions and "identified three criteria courts generally consider: (1) the plain language used by the General Assembly in the amendment itself; (2) any case law or agency decision indicating the prior statute was susceptible to differing interpretations; and (3) legislative history surrounding the amendment."

In determining that the amendment to KRS 61.970(1)(h) did not merely clarify the law, the Court analyzed these three criteria. First, the Court noted the plain language of the amendment suggested the General Assembly intended the changes as only a clarification. Second, the Court analyzed the history of the ORA and noted that the Act remained virtually unchanged for over thirty-five years. The Court found this to be convincing evidence that the General Assembly intended the amendment as a substantive change and not a mere clarification. Third, the Court noted, "There appears to be no prior case law by our courts deeming this portion of the ORA ambiguous." The Court thus concluded that the amendment to KRS 61.970 was a substantive change to the law and should not apply retroactively.

The Court of Appeals denied UMG's petition for rehearing, and UMG filed a motion for discretionary review with the Kentucky Supreme Court. The Court granted review on June 8, 2016.

3. *Ark Encounter, LLC v. Parkinson*, Eastern District of Kentucky, Civil Action No. 15-13-GFVT (E.D. Ky. January 25, 2016).

In a high profile case, the U.S. District Court for the Eastern District of Kentucky held a religious-themed tourist attraction, even one advancing religion, meeting the neutral criteria for tax incentives offered by the Commonwealth of Kentucky cannot be denied those incentives based upon the Establishment Clause of the U.S. and Kentucky Constitutions. The case was filed against the Kentucky Tourism, Arts and Heritage Cabinet (the "Cabinet") by Ark Encounter, LLC, and its related entities (collectively, "Ark Encounter"). Ark Encounter is engaged in building a theme park in Northern Kentucky centered on a full-scale replica of Noah's Ark. Ark Encounter sought a preliminary injunction challenging the Cabinet's denial of sales tax incentives under the Kentucky Tourism Development Act (the "KTDA"). The Cabinet moved to dismiss the complaint on the basis that allowing Ark Encounter to participate in the state's incentive program would violate the prohibition against establishing a religion under both the federal and state constitutions.

The Court rejected the Cabinet's argument, holding Ark Encounter's participation in the incentive program would *not* violate the Establishment Clause. As an initial matter, the Court noted that some interaction between church and state is "inevitable". The question, however, is whether such interaction creates an impermissible establishment of religion. The Court focused on the KTDA's *secular* legislative purpose of relieving unemployment by preserving and creating jobs through tourism projects and also creating sources of tax revenue through the projects and their attraction of out-of-state tourists. Specifically, the Court noted, nothing in the KDTA indicates its purpose is to aid or give preference to a particular religion. Instead, the language of the KDTA is neutral.

The Court also concluded Ark Encounter's participation in Kentucky's incentive program would not result in the government's endorsement of religion, nor would it create an excessive government entanglement with religion. By contrast, excluding Ark Encounter from the program because of its religious nature *would* result in excessive government entanglement with religion because it would require state officials to scrutinize applicants' beliefs to ensure the proposed projects were either secular or at least not "too religious". The government could avoid such entanglement, the Court stated, by approving all programs meeting the neutral requirements of the incentive program.

Furthermore, the Court held the Cabinet's exclusion of Ark Encounter from participating in the program violated Ark Encounter's free exercise and free speech rights under the First Amendment. The Court noted the Cabinet's actions forced Ark Encounter to choose between expressing its religious views on its own property and receiving tax incentives under the KTDA. Therefore, the Court denied the Cabinet's motion to dismiss and entered a preliminary injunction prohibiting the Cabinet from excluding Ark Encounter from Kentucky's tax incentive program based upon its religious purpose and message.

4. *Suzette Sewell-Scheuermann as Taxpayer for the Use and Benefit of the City of Audubon Park v. Michael Scalise*, Kentucky Court of Appeals, Case No. 2014-CA-000915 (April 15, 2016), *motion for discretionary review filed*, Kentucky Supreme Court, No. 2016-SC-000246 (May 13, 2016).

In this appeal, the Kentucky Court of Appeals held the Mayor of the City of Audubon Park and seven members of the City Council ***personally liable*** for $677,000 of funds raised by a sanitation tax but diverted over a five year period to pay other, non-sanitation expenses of the City.

Beginning July 1, 2007 and annually thereafter the City Council approved ordinances setting a "sanitation tax" which was a fixed amount billed separately as an annual charge on the City of Audubon Park property tax bills. As described by the City's website, "households are assessed a fee for garbage/yard waste/recycling collection/storm damage reserve" included with the annual property tax bill which "amount varies due to contract terms with the waste management vendor." The ordinances specified that the tax was levied for the purpose of paying for sanitation services for the City, including garbage and trash collection, as well as recycling.

A taxpayer and resident of the City filed suit alleging that each fiscal year the City Council diverted a portion of the tax revenue generated by the sanitation tax and placed the funds in the City's general fund, where the revenue was expended on items unrelated to sanitation. The taxpayer alleged that the Mayor and City Council Members who voted to allow the expenditure of sanitation tax revenue on unrelated items violated Section 180 of the Kentucky Constitution, KRS 92.330 and KRS 92.340. The taxpayer sought a judgment against these individuals equal to the unauthorized expenditures.

Section 180 of the Kentucky Constitution provides in relevant part that "every ordinance and resolution passed by any county, city, town or municipal board or local legislative body, levying a tax, shall specify distinctly the purpose for which said tax is levied, *and not tax levied and collected for one purpose shall ever be devoted to another purpose.*" KRS 92.330 contains a similar requirement. KRS 92.340 provides for personal liability and authorizes a taxpayer relator action:

> If, in any city of the home rule class, any city tax revenue is expended for a purpose other than that for which the tax was levied or the license fee imposed, each officer, agent or employee who, by a refusal to act, could have prevented the expenditure, and the members of the city legislative body who voted for the expenditure, shall be jointly and severally liable to the city for the amount so expended. The amount may be recovered of them in an action upon their bonds, or personally. The city attorney shall prosecute to recovery all such actions. If he fails to do so for six (6) months after the money has been expended, any taxpayer may prosecute such action for the use and benefit of the city. A recovery under this subsection shall not bar a criminal prosecution. Any indebtedness contracted by a city of the home rule class in violation of this subsection or of KRS 92.330 or 91A.030(13) shall be void, the contract shall not be enforceable by the person with whom made, the city shall never assume the same, and money paid under any such contract may be recovered back by the city.

The trial court held that there were no damages because the diverted funds were applied to the legal obligations of the City, and therefore, the City was not actually harmed. The trial court dismissed the complaint, and the taxpayer appealed.

The Court of Appeals held that Section 180, KRS 92.330 and KRS 92.340 simply mean what they say and the taxpayer satisfied all elements necessary such that the Mayor and City Council Member should be held to be "jointly and severally liable to the city" for the amount of sanitation tax revenue that they allowed to be expended for matters other than sanitation. The

Court found no indication in the statutory language that the General Assembly intended to exempt liability if the officials use the funds on other city-related liabilities. The Court agreed with the taxpayer that this is the very action KRS 92.330 and 92.340 prohibit. The Court distinguished cases addressing funds raised for a specific purpose which become surplus once the purpose has been achieved. "[I]n the case of taxes which repeat each year, leftover revenues generated in one year should be used for that purpose, either in the year levied or some other year." Op. at 7. The Court also noted that any excess funds after payment of the City's contract for sanitation should be used for sanitation in the following year "since there is no way to refund a tax that was lawfully levied and collected." Op. at 8.

The Mayor and City Council Members have moved for discretionary review by the Kentucky Supreme Court.

C. Administrative Developments.

1. Governor Abolishes Kentucky Board of Tax Appeals.

On August 8, 2016, Governor Matt Bevin issued Executive Order 2016-576 abolishing the KBTA, the Board of Claims and the Crime Victims Compensation Board. The Order reorganizes all three Boards into the Kentucky Claims Commission effective October 1, 2016. The Governor has tasked three individuals - Marcus Carey, Carlo Wessels and Jessica Burke - all of whom are attorneys and each of whom had been appointed to the KBTA, to "study and plan the best procedures to follow in transitioning the functions, records and cases of [the three] boards to the Kentucky Claims Commission." Notably, the Order gives the new Commission authority to issue regulations that "establish hearing procedures, dollar thresholds for the requirement of a full Commission hearing as opposed to a determination from a single member or employees, and <u>for the approval of attorney's fees</u> for representation before the Commission." (Emphasis Added.) Although it is too soon to know whether the Commission will issue such a regulation, permitting a taxpayer to recover attorney's fees would constitute a very positive development.

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.

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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 Kentucky Department of Revenue, the Kentucky Board of Tax Appeals 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").

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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 represents Kentucky, regional and national companies in their state and local tax matters, including policy, lobbying, controversies and litigation. She represents clients of varied industries before the Kentucky Department of Revenue, the Kentucky Board of Tax Appeals, and before the courts of Kentucky. Ms. Smart also represents clients before the Kentucky General Assembly regarding legislative and regulatory matters. She was formerly a Staff Attorney and Attorney Manager with the Kentucky Department of Revenue's Office of General Counsel, Legal Services for Revenue.

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 tax law for several years. Ms. Smart is a registered Legislative Agent, a member of the Broadband Tax Institute, a practitioner member of COST and is a Regional Editor of the American Bar Association Property Tax Deskbook. She 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

Stephen A. Sherman serves as Counsel to the Firm 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.

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After receiving her Bachelor of Journalism in strategic communications in 2008 at the University of Missouri, Ms. Schueler earned her Juris Doctor in 2011 from the University of Louisville. There, she was a member and notes editor of the *University of Louisville Law Review*, and she has been recognized for her distinguished writing skills. Ms. Schueler served as the Co-Regional Editor of the American Bar Association Property Tax Deskbook in 2015 and 2016. Prior to SKO, she worked as a law clerk for U.S. Magistrate Judge Hanly A. Ingram in London, Kentucky. Ms. Schueler was elected Associate of the Central Kentucky American Inn of Court in 2015.

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