

Kentucky Tax Developments – Fall 2021

Dentons SALT Insights

KEY CONTACTS

Mark Loyd
Bailey Roese
Brett Miller
Stephanie Bruns
Jeff Bennett
Brad Hasler
Kelli A. Wikoff
Kimberly M. Nolte
Gary R. Thorup
Eric Smith

I. Senate Bill Abolishes the KCC and Reinstates the KBTA

Kentucky Senate Bill 162, passed by the General Assembly on March 30, 2021 and signed by Governor Andy Beshear on April 5, 2021 codified by the Governor's August 31, 2020 executive order abolishing the Kentucky Claims Commission (KCC) and reinstating the Kentucky Board of Tax Appeals (KBTA) as part of a reorganization of the Public Protection Cabinet. Senate Bill 162 (SB 162) confirmed the Executive Order in many respects; however, new judicial qualifications were added for the Board Members, which resulted in a further reorganization from the initial panel appointed under the Executive Order.

The Board of Tax Appeals will consist of a three-member panel, each appointed by the Governor and subject to Senate confirmation serving staggered terms of four years. There is no limit on the number of reappointments. To qualify as a member of the Board of Tax Appeals, two members must be attorneys having the same qualifications required of candidates for a Circuit Judge with one having a background in taxation. The Governor shall designate one member as the chairperson, who must be an attorney. The law specifies that "no member shall engage in any occupation of business inconsistent with his or her duties as a member."

SB 162 also expanded the exclusive jurisdiction of the KBTA to hear and determinate appeals from final rulings, orders, and final determinations of any revenue and taxation agency which affects review and taxation, with all appeals being heard by the full board. Previously, the KCC/KBTA was tasked only with hearing and determining tax appeals from final determinations of state and county government. With the newly expanded jurisdiction, the KBTA may now also hear appeals from any local government agency, including special taxing districts. Previously, such appeals were required to be appealed to the Circuit Court.

The KBTA took over all cases which were pending before the KCC. Final rulings of the KBTA may be appealed to the appropriate Circuit Court, and SB 162 eliminated the proposed condition that full payment or a bond would be required prior to judicial review, which would have essentially made Kentucky a “pay-to-play” state with respect to tax appeals.

The change comes only four years after the initial formation of the KCC. Gov. Beshear cited to “efficiency and economy of the government and more effective delivery of services” as rationale for the change, which includes the formation of the Office of Claims and Appeals. The Office of Claims and Appeals shall comprise three administrative boards: The Board of Tax Appeals, the Board of Claims, and the Crime Victims Compensation Board. As further explanation, the Governor noted that the KCC created inefficiencies in the resolution of tax appeals, with a backlog of approximately 60 cases. This backlog impacted both the Commonwealth’s ability to raise revenue and taxpayers’ due process rights.

II. Kentucky Taxes & COVID-19

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

A. Nexus and Telecommuting

The Covid-19 Pandemic brought about many changes, including where a business’s employees work. For employers employing Kentucky residents and/or nonresidents who reside in states with which Kentucky has a reciprocal agreement, they will not need to change their current withholding practices during the period when these employees are working from home. Requirements for withholding of tax in either case remain unchanged by restrictions related to the Covid-19 pandemic and resulting emergency procedures. The Department will continue reviewing Kentucky income tax nexus determinations on a case-by-case basis, though companies should continue to keep in mind federal Public Law 86-272, which prohibits states from imposing income tax on a business’s income derived from interstate commerce if the business has only limited business activity in the state.

B. Kentucky Adopts Federal Treatment of PPP Income and Expenses

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

C. KDOR Resumes Collections

On March 23, 2021 the Department announced that the Division of Collections resumed collection activity on June 11, 2021. Collection action was previously suspended due to the COVID-19 emergency. The Department encourages those who owe a balance to contact the Department.

All of the Department’s Coronavirus updates can be found at revenue.ky.gov/Pages/2019NovelCoronavirus.aspx.

III. 2021 Legislative Changes

The 2021 legislative session saw several pieces of tax legislation, ranging from the reorganization of the KBTA noted above to clean-up changes.

Modified Requirements for Retailers with Economic Nexus

Increasing the time for a remote seller or a marketplace provider to register from 30 days to 60 days after the economic nexus threshold is met for SSUTA compliance. Allowing a marketplace provider to obtain either a single permit number or two permit numbers to separately report facilitated sales on the additional permit.

Repeal of the Bank Franchise Tax

For tax years beginning after January 1, 2021, banks previously subject to the bank franchise tax will be subject to the corporate income tax. The bank franchise tax will be completely phased out in 2022. Though, 2019 H.B. 458 clarifies that financial institutions would still be subject to all applicable local government franchise taxes. Similarly, H.B. 458 repeals the savings and loan tax and would subject all savings and loan associations to the corporate income tax for years beginning on or after January 1, 2021.

Cryptocurrency “Mining” Tax Exemptions

Through provisions in H.B. 230 and S.B. 255, Kentucky has provided for sales and use tax exemptions for electricity and tangible personal property directly used in the commercial mining of cryptocurrency. The exemption is obtained through application and the exemptions effective as of the date of approval. This exemption went into effect on July 1, 2021, with a 4-year sunset. The amount of the exemption must be reported to the Department on November 1 each year, beginning on November 1, 2021.

Economic Development Incentives for \$2 billion Investments

Senate Bill 5, signed by Gov. Beshear on September 9, 2021 designated hundreds of millions of dollars to fund several economic incentives to draw large investment projects of \$2 billion or more to the state. A significant portion of the funding, \$350 million, is allocated to fund forgivable loans from the Kentucky Economic Development Finance Authority (“KEDFA”). Unlike Kentucky’s other economic development incentive programs – such as the Kentucky Business Investment program, the Kentucky Enterprise Initiative, and the Economic Development Fund program, recipients of KEDFA loans will be subject to Kentucky sales and use tax, Kentucky income tax, limited liability entity tax, and payroll withholding. The law also allocates approximately \$10.6 million to pay off loans associated with a property in Hardin County to allow the property to be used for major manufacturing, processing, and assembling facilities. An additional \$5 million is designated for training grants under KCTCS-TRAINS to be determined by the Kentucky Community and Technical College System, and \$25 million for the construction of an on-site training center in Hardin County. The bill was signed under an emergency clause and was thus immediately effective upon signing.

Clean-Up Changes in 2021 HB 249

2021 HB 249 made several clean-up changes to: electronic transmission of workpapers in the Taxpayer Bill of Rights, clarifying the tax on open vaping systems applies only on solution, exempt rentals and leases from Motor Vehicle Usage Tax by the US, Kentucky, and Kentucky political subdivisions. The bill also deleted certain provisions related to, *inter alia*, corporate partners/members/shareholders from KRS 141.206 (pass-through entities) and KRS 141.207 (estimated payments) to remove withholding on corporate partners/members/shareholders and to eliminate composite returns for individuals. The bill also treats the veteran service organization as an institution of purely public charity exempt from property tax, effective January 1, 2022.

IV. Select Case Updates

LWAGLVKY 1, LLC, et al. c/o Walgreen Co. v. Jefferson Co. PVA, et al., No. K19-S-88, 207-210 (Ky. Bd. Tax App. Aug. 25, 2021), on appeal 21-CI-005434 (Jefferson Cir. Co. Sept. 24, 2021) – Property Tax

The KBTA issued its Final Order in *LWAGLVKY 1, LLC, et al. c/o Walgreen Co. v. Jefferson County PVA, No. K19-S-88, 207-210* (Ky. Bd. Tax App. Aug. 25, 2021) concerning the assessment value of 15 properties leased by Walgreens throughout the Louisville Metro Area. Walgreens obtained fee simple appraisals for each property, using local market conditions and market rent, and argued that the fee simple appraisals represented the fair cash values for the properties under Kentucky law. PVA put forth evidence of a leased fee valuation for each property, using above-market contract rent and national sales, arguing that the value of the leased fee represented the properties' fair cash value for *ad valorem* tax purposes. The KBTA held that, through its presentation of evidence, Walgreens overcame the presumption in favor of the PVA's valuation. The KBTA found in favor of Walgreens for the two Walgreens-owned properties, but sided with the PVA on the 13 properties with leases. The KBTA made no findings concerning Walgreens' constitutional claims that the PVA's assessments violate uniformity and equal protection when PVA's assessments were double or more than those of comparable retail properties in the county. Walgreens appealed the KBTA's order concerning the 13 leased properties and the constitutional claims to Jefferson Circuit Court.

Century Aluminum of Ky. v. Dep't of Revenue, No. 19-CI-00424 (Franklin Cir. Ct. Feb. 3, 2020), affirmed 2020-CA-0301-MR (Ky. App. July 9, 2021) – Sales Tax – Manufacturing Supplies Exemption

The Court of Appeals upheld the decision of the circuit court in *Century Aluminum of Ky. v. Dep't of Revenue*, holding that the circuit court properly interpreted the statutes and concluding that the certain items which were worn out during the manufacturing process and used "to maintain, restore, mend, or repair machinery or equipment" and, therefore, were taxable repair, replacement or spare parts.

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

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

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

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

Haier US Appliance Solutions, Inc. v. Jefferson Co. PVA, et al., No. K17-S-105, Order No. K25929 (KCC June 25, 2019), reversed, No. 19-CI-4516 (Jefferson Cir. Ct.), dismissed on appeal, 2020-CA-1234 & 1262 (Ky. App. June 9, 2021) – Property Tax

In *Haier*, the PVA assessed the property at \$123,091,000 based on the value

as stated in the deed. The hearing officer in the case proposed a recommended order reversing the PVA's assessment and valuing the property at an appraisal value of \$27,300,000. The KCC/KBTA's final order rejected the recommended order, finding that the consideration written in the deed is generally consistent with the fair market value reported to the IRS and for financial accounting purposes, and that the consideration recited in the deed was supported by an appraisal obtained by or at the direction of the taxpayer. So, the KCC/KBTA affirmed the PVA's assessment. The Jefferson Circuit Court reversed the KCC/KBTA; the Court of Appeals dismissed the appeal by joint agreement of the parties.

Ridge v. Dep't of Revenue, No. 2018-CA-001517 (Ky. App. Aug. 16, 2019), discretionary review denied (Ky. Sept. 16, 2020) – Out-of-State Tax Assessments – Income Tax

In *Ridge*, the Kentucky Court of Appeals held that severance payments to a nonresident former employee in exchange for non-compete and non-solicitation agreements were properly subject to Kentucky income tax as wages. Taxpayer was a Tennessee resident who worked in Kentucky and after his retirement received biweekly payments in exchange for being bound by non-compete and non-solicitation agreements. His employer withheld Kentucky state income taxes, and the taxpayer sought a refund. Taxpayer argued that the payments were paid post-retirement and were not connected to any Kentucky activities. The Court of Appeals disagreed and held that severance payments are made in consideration of employment and thus are wages subject to income tax. The Court held that such payments are considered wages for federal income tax purposes and thus subject to withholding in Kentucky. The Kentucky Supreme Court declined discretionary review.

Kroger Ltd. P'ship I v. Boyle Cty. Prop. Valuation Adm'r, File No. K16-S-25, Order No. 25353 (KBTA Sept. 26, 2017), remanded, 17-CI-00385 (Boyle Cir. Ct. May 14, 2018), reversed, 2019-CA-000935 (Ky. App. Aug. 14, 2020) – Property Tax – Evidentiary Rules

In *Kroger Ltd. P'ship I v. Boyle Cty. Prop. Valuation Adm'r*, No. 2019-CA-000935-MR, 2020 WL 4722042 (Ky. App. Aug. 14, 2020), the Kentucky Court of Appeals considered Kroger's appeal of the assessment value of one of its stores for real property tax purposes and in so doing laid out evidentiary rules for a real property tax case at the Kentucky Claims Commission (now the Kentucky Board of Tax Appeals).

As to evidence, Kroger offered the expert testimony and appraisal report of a certified property appraiser employing two approaches to value the property: the sales comparison approach and the income approach. The PVA presented testimony of the PVA who relied on a summary report prepared by the Department using a cost approach.

The Court of Appeals opined that the PVA's valuation is an evidentiary presumption that must be presumed correct unless rebutted by competent evidence. Once Kroger presented such evidence, *i.e.*, the expert testimony and appraisal report, the presumption disappeared. Kroger not only presented evidence supporting a contrary value, but also presented evidence which cast doubt on the assumptions relied upon in the PVA's assessment. Kroger's evidence was sufficient to rebut the statutory presumption of the validity of the PVA's assessment. Nevertheless, Kroger retained the ultimate burden of proof and risk of non-persuasion to establish the value of the property.

As long as the PVA relied upon a properly supported valuation, the KCC/KBTA was not obligated to accept the valuation provided by Kroger's expert. However, the KCC/KBTA did not set forth any significant reasons for rejecting the valuation offered by Kroger's expert. The KCC/KBTA only stated that Kroger's expert's testimony failed to establish that the valuation provided by the PVA was incorrect. The KCC/KBTA did not state any reasons for finding Kroger's expert testimony or conclusions to be unsupported. Without a sufficient foundation to support the PVA's valuation or stated basis to reject Kroger's valuation, there was no admissible evidence to support any valuation other than Kroger's.

Accordingly, the Court of Appeals agreed with Kroger that the PVA failed to carry its burden of going forward with evidence to establish that the PVA's valuation of Kroger's property was competent and reliable. In *Kroger v. Boyle PVA*, the Court of Appeals also provides a concise summary of evidentiary rules applied to a typical real property tax dispute.

***Stanford Water and Sewer Comm'n v. Lincoln County, et. al*, No. 18-CI-00062 (Lincoln Cir. Ct.), 2019-CA-001247-MR (Ky. App. Sept. 11, 2020) – Local Tax – Jurisdiction**

This decision by the Kentucky Court of Appeals concerned the validity of a county ordinance which imposed a \$4.00 fee on all active water service within the county for the purpose of funding the county's emergency 911 services. Specifically, the ordinance required any entity operating a water distribution system within the county to collect the fee from its consumers and remit it to the county.

Cities within the county alleged that the ordinance was unlawful on the basis that KRS 96.170 grants cities exclusive authority to regulate the price of water and that the county could not require water companies to collect the additional fee.

Affirming the judgment of the Lincoln Circuit Court, the Kentucky Court of Appeals upheld the ordinance as valid under Kentucky law. The Court determined that KRS 96.170 was a basic grant of authority that did not specifically grant cities exclusive jurisdiction over water prices and that it did not prohibit other governmental entities from adding a tax or fee to the price of water, so long as the governmental entity had such authority. The Court found that the county had such authority under KRS 65.760 which grants the county wide latitude to provide public services and enact ordinances to carry out public functions, including the provision of hospitals, ambulance services, and police and fire protection.

Because the additional water fee was for the funding of 911 services, which involved hospitals, ambulance services, and police and fire protection, KRS 65.760 allows for the imposition of the fee since it is not limited by any other statute. Citing to prior case law, the Court found that "any limitation cannot be implied and must be an express restriction."

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

In *Agree Hazard KY, LLC dba Walmart v. Perry County Property Valuation Administrator & Perry County Board of Assessment Appeals*, No. K17-S-163, the KCC/KBTA reversed the Perry County Board of Assessment Appeals ("BAA") and found that the subject property located in Hazard, Perry County, Kentucky, should be assessed using a value derived from the contract rent generated on the property and noted that such contract rent was a vital factor and must be considered when assessing the property. Such a finding was a notable departure from the recommendations from the Hearing Officer, who had found the contract rent to be above-market and thus inapplicable.

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

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

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

V. Other Insights Into Kentucky Law

Kentucky Property Taxes on Commercial Real Estate

As noted in the selected case updates above, property taxes, especially real property taxes, matter to businesses or non-profits with locations in Kentucky, because such taxes often present a material cost that may be either managed so only the appropriate amount of tax is levied or avoided when an exemption applies.

With real property taxes, it is best to think about procedure first. This is because applicable administrative procedures for real property taxes must be exhausted to obtain relief. *Cromwell Louisville Assocs. v. Jefferson Cnty. Prop. Valuation Adm'r*, 323 S.W.3d 1 (Ky. 2010). And, real property tax administrative procedures differ from those other taxes, are complicated and involve tight time frames.

Substantive tax issues are constitutional in nature. The Kentucky Constitution requires that real property be valued at its fair cash value. Ky. Const. § 172. Constitutional protections of uniformity and equal protection inure to taxpayers. Ky. Const. §§ 2 & 171-74; U.S. Const. amend. XIV. And, the Kentucky Constitution provides for property tax exemptions for institutions of religion, institutions of purely public charity, and for institutions of education as well as for public property used for public purposes. Ky. Const. § 172.

Procedure - "This is not 'Nam. This is bowling. There are rules." Walter Sobchak in *The Big Lebowski* (1988).

Procedural rules are very important in property tax. Although, in Kentucky, the County Sheriff sends out property tax bills for real property in the fall, the time to contest a real property tax assessment value is the spring which is when the county property valuation administrator (PVA) is required to give taxpayers notice of changes in their assessment values. KRS 132.450. Even if the PVA does not change the assessment value from the prior year's value, a taxpayer may dispute the current year's value. This may happen, for example, when the value of a property decreases or when the taxpayer, for whatever reason, did not dispute the value in the prior year.

A taxpayer initiates the process of contesting a real property tax assessment value by requesting a conference with the PVA for the county in which the property is located before end of the “open inspection” period, the 13-day period beginning on the first Monday in May. KRS 133.120; KRS 133.045. The process applies throughout Kentucky, whether your real estate is located in Jefferson County, Fayette County, Boone County or any other Kentucky County.

The PVAs’ position is that the request required by statute for a PVA conference must be filed with the PVA before the end of the open inspection period; otherwise, the right to appeal is lost. PVAs typically send the notice via first class mail, which can be quite unreliable. So, what happens if the taxpayer does not receive the PVA’s notice of change in value? What happens if the notice is delayed, lost, or misdelivered? A taxpayer has a constitutional right to due process.

Oftentimes, the PVA conference will result in a resolution but not always. A taxpayer that is still aggrieved by an assessment may appeal to the Board of Assessment Appeals (BAA) in the county in which the property is located. KRS 133.120. A taxpayer or the PVA aggrieved by the BAA’s decision, may appeal to the Kentucky Board of Tax Appeals (KBTA). KRS 133.120. As this point, a real property tax appeal is handled similarly to any other tax appeal and may then be appealed to a Circuit Court, then to the Kentucky Court of Appeals, the Kentucky Supreme Court, or to the United States Supreme Court, assuming that the matter is not resolved by agreement, which can occur at any time during the process.

A CPA or an attorney as well as certain other representatives may represent a taxpayer before the PVA and the BAA. But, beginning with the KBTA, a party that is not an individual, must be represented by an attorney authorized to practice law in Kentucky; otherwise, the KBTA has been known to dismiss appeals filed by a non-attorney. 802 KAR 1:010.

Fair Cash Value - “Yeah, well, you know, that’s just, like, your opinion, man.” The Dude.

Opinions can differ about what the fair cash value of a property is. However, real property taxation in Kentucky is governed by constitutional law, as noted above, and the Kentucky General Assembly has recognized this:

The General Assembly recognizes that Section 172 of the Constitution of Kentucky requires all property, not exempted from taxation by the Constitution, to be assessed at one hundred percent (100%) of the fair cash value, estimated at the price the property would bring at a fair voluntary sale, and that it is the responsibility of the property valuation administrator to value property in accordance with the Constitution.

KRS 132.191(1). Significantly, PVAs are directed to assess property as its fair cash value in accordance with the Constitution at the price the property would bring in a fair voluntary sale.

Evidence of fair cash value may take the form of three statutorily recognized valid valuation methods: the cost approach, the sales comparison approach and the income approach. KRS 131.191. The “cost approach” is “a method of appraisal in which the estimated value of the land is combined with the current depreciated reproduction or replacement cost of improvements on the land...” *Id.* The “sales comparison approach” is “a method of appraisal based on a comparison of the property with similar properties sold in the recent past...” *Id.* The “income approach” is “a method of appraisal based on estimating the present value of future benefits arising from the ownership of the property.” *Id.* Kentucky property tax cases use these three approaches to value in determining the fair cash value of a property.

When a property is sold, the PVA will often assess the property for the value disclosed on the deed; however, the deed value is not always the same as the fair cash value. Because of this, disputes can arise regarding the value. For example, in *Haier US Appliance Solutions, Inc. v. Jefferson Co. PVA, et al.*, No. K17-S-105, Order No. K25929, reversed, No. 19-CI-4516, (Jefferson Cir. Ct.), *appealed*, 2020-CA-1234 & 1262 (Ky. App.), the Jefferson County PVA assessed a property at the value reflected on the deed, and the taxpayer contested the value. While the KBTA's hearing officer issued a Recommended Order setting the fair cash value at an amount different than the deed value, the KBTA declined to adopt it and instead issued its Final Order setting the fair cash value at the deed value; the Jefferson Circuit Court reversed the KBTA, and both parties appealed. Clearly, reasonable minds may differ.

Somewhat recently, PVAs in several counties have been assessing leased properties at an assessment value determined using a formula that takes the contract rent of the long-term lease and divides it by a capitalization rate determined by reference to the remaining term of the lease and the creditworthiness of the tenant; when leases are at above market rates, this formula results in an assessment value that is substantially higher than nearby similar properties. Kentucky's highest court has soundly rejected this, holding that the fair cash value is the value of the property itself. *Fayette Cty. Bd. of Sup'rs v. O'Rear*, 275 S.W.2d 577 (Ky. 1954). It would seem that the *O'Rear* case should halt the PVA's practice.

Uniformity and Equal Protection - "Careful man, there's a beverage here!" The Dude.

When it seems like your property is being over-assessed or someone else's property is being under-assessed, there is somewhere to turn. The Kentucky Constitution and the United States Constitution provide protection to taxpayers with regard to their property taxes in relation to other properties. The Kentucky Constitution mandates that "[t]axes...shall be uniform upon all property of the same class subject to taxation within the territorial limits of the authority levying the tax." Ky. Const. § 171. Similarly, the United States Constitution (Equal Protection Clause of the Fourteenth Amendment) and the Kentucky Constitution (Section 2) guarantee equal protection under the laws, including Sections 171 to 174 of the Kentucky Constitution. "The Equal Protection Clause 'applies only to taxation which in fact bears unequally on persons or property of the same class.'" *Allegheny Pittsburgh Coal Co. v. Cty. Comm'n of Webster Cty., W. Va.*, 488 U.S. 336, 343 (1989).

What happens when a real property taxpayer believes that other properties are being under-assessed in violation of uniformity or equal protection? There is a procedure for such a taxpayer to request the county BAA to review assessments of such under-assessed properties, though such procedure is not limited to constitutional violations. KRS 133.120(2)(g). There is similar procedure in KRS 133.120(2)(f) for local governmental entities, though this latter circumstance does not implicate uniformity or equal protection concerns as does the former circumstance. Interestingly, in *Grant County Board of Education v. Ark Encounter, LLC*, No. 19-CI-00204 (Grant Cir. Ct. July 29, 2020), *affirming*, File No. K18-S-15, Final Order No. K-25927 (KCC May 31, 2019), the Grant County Board of Education attempted to appeal a BAA decision to the KBTA regarding the PVA's property tax assessment of property owned by Ark Encounter, LLC. The KBTA dismissed the appeal because the Board of Education was not the PVA or a taxpayer, who has a right of appeal under KRS 133.120.

What about the opposite situation? A taxpayer's property may be over-assessed in relation to other properties; *i.e.*, while other properties are assessed at their fair cash value, the subject property is assessed at more than its fair cash value. In such an instance, a taxpayer would raise the issue of the violation of uniformity or equal protection in disputing the value of their property, first with the PVA, then the BAA, then the KBTA, etc.

Constitutional Exemptions - "The Dude abides." The Dude.

Exemptions from property tax are provided by the Kentucky Constitution. Section 170 provides for multiple real property tax exemptions, including: public property used for public purposes; real property owned and occupied 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 solely to the cause of education. Also, while not technically an exemption, Section 172A provides "for the assessment for *ad valorem* tax purposes of agricultural and horticultural land according to the land's value for agricultural or horticultural use" which is provided for in KRS 132.450; the practical effect of this is that agricultural land is generally valued at a lower value. With these constitutionally-provided exemptions, disagreements between PVAs and taxpayers arise periodically regarding the scope of the exemption.

Exemption issues can arise in the context of commercial property. For example, in *Freeman v. St. Andrew Orthodox Church, Inc.*, 294 S.W.3d 425 (Ky. 2009), a question arose regarding the application of the exemption for real property owned and occupied by institutions of religion to houses being rented to individuals on property owned by a church. In holding that the rental houses did not meet the "occupied" requirement, the Kentucky Supreme Court noted that to hold otherwise "would extend the exemption to property owned by the church and rented as commercial real estate, including shopping centers and other commercial enterprises." *Id.* Real property, however, that is owned and occupied by institutions of religion would come within the clear text of the exemption.

With certain notable exceptions, "When any real ... property which is exempt from taxation is leased ... in connection with a business conducted for profit, the leasehold ...[is] subject to state and local taxation..." KRS 132.195(a). This can arise, for example, when property owned by a purely public charity is leased to a business. The question then becomes, what is the value of the leasehold? The law is well-settled that a leasehold's fair market value for taxation purposes is obtained by subtracting the fair market value of the real property with the leasehold from the fair market value of the real property without the leasehold. *Grand Lodge of Kentucky Free and Accepted Masons, et al. v. City of Taylor Mill et al.*, 2015-CA-001617-MR (Ky. App. 2017).

Examples illustrate this concept. Suppose that the fair cash value of the property without the leasehold was \$1,000,000. If the lease is a below market lease, say for annual rent of \$1, then the fair cash value of the property with the leasehold would be \$0, and the fair cash value of the leasehold would be \$1,000,000, which would be subject to tax. This makes sense because all of the value is in the lessee's hands. Conversely, if the lease is an above market lease, say for annual contract rent of \$200,000 with a capitalization rate of 10%, the value of the property with the lease would be \$2,000,000 (\$200,000/10%); so, the value of the leasehold would be \$0 (the value of the property without the lease of \$1,000,000 less the value of the property with the lease of \$2,000,000), and none of the value of the fair cash property would be subject to tax. This makes sense because all of the value is in the lessor's hands.

Note that the maximum fair cash value of the property is the value without the leasehold, which is consistent with *O'Rear, supra*.

"This is a very complicated case Maude. You know, a lotta ins, a lotta outs, lotta what-have-yous." The Dude.

Property tax is simple on the surface. It is all about value. However, it is really very complicated, with a lotta ins, a lotta outs, lotta what-have-yous, especially since it is rooted in constitutional law. And when you feel like you are right, just remember what the Dude would say – "This aggression will not stand, man."

Kentucky Taxpayer Protections' Role in Audits and Appeals

As Abraham Lincoln once said, "It is ... the duty of Government to render prompt justice against itself in favor of citizens..." *Calvert Invs., Inc. v. Louisville & Jefferson County Metro. Sewer Dist.*, 805 S.W.2d 133, 138 (Ky. 1991) (quoting Abraham Lincoln). Equally, in a tax audit, the tax auditor's job is to determine the right amount of tax, regardless of whether the audit determines that the taxpayer paid that amount, too little or too much. Indeed, Kentucky tax auditors cannot be evaluated "on the basis of taxes assessed or collected". KRS 131.081(13)(a). Taxpayer protections provided for and embedded in Kentucky tax statutes enacted by the General Assembly help ensure that taxpayers pay only the amount of tax that is due under Kentucky tax law – which is as it should be.

Taxpayer's Right to Guidance from the Department of Revenue

An ounce of prevention is worth a pound of cure. Trying to get taxpayers, their advisers and the Department all on the same page reduces uncertainty and increases not only compliance but disputes on audits between taxpayers and the Department. Taxpayers cannot read the Department's mind; so, the Department must provide guidance regarding its positions – the more guidance, the better!

Importantly, the Kentucky Taxpayers' Bill of Rights provides that, "The department shall develop and implement a Kentucky tax education and information program directed at new taxpayers, taxpayer and industry groups, and department employees to enhance the understanding of and compliance with Kentucky tax laws, including the application of new tax legislation to taxpayer activities and areas of recurrent taxpayer noncompliance or inconsistency of administration." KRS 131.081(1). So, the Department is statutorily directed to provide guidance. And, thanks to amendments made to KRS 131.130(8) by 2017 HB 245, such guidance may include examples, and thus, the Department's examples may provide additional clarity to taxpayers.

Ideally, a taxpayer should have a good understanding of the tax law and the Department's positions prior to an audit. That said, taxpayers and the Department are not always in agreement on the meaning of every provision of the tax law – differences exist. They always have.

Right to Know Procedures, Remedies and Rights

At the beginning of a tax audit, a taxpayer should understand the procedures for the audit and rights and remedies should the taxpayer and the Department disagree on all or a part of the audit. Procedures, remedies and rights safeguard the system by making it more likely that an audit will ultimately (sometimes after protests and appeals) result in what the taxpayer owes under Kentucky tax law. Given the importance of procedures, remedies and rights, the Department is required to inform taxpayers of these with its initial notice of audit, each original notice of tax due, and each denial of a refund or credit. KRS 131.081(2).

Each Taxpayer's Right to Representation

Many taxpayers, individuals and businesses are not sophisticated in tax matters, and most small and mid-sized businesses do not have tax professionals on staff; they rely on their outside tax advisers. Taxpayers "have the right to be assisted or represented by an attorney, accountant, or other person ... before the department." KRS 131.081(3). When a taxpayer's tax adviser understands the taxpayer's business and their tax situation and has experience in handling audits, the taxpayer's representative can facilitate the audit process.

Statutes of Limitation

An audit may only be performed on "open" tax periods, *i.e.*, tax periods for which the applicable statute of limitations period has not expired, often referred to as being "closed." For example, sales and use tax must be assessed within four years from the date the return was filed. KRS 139.620. Similarly, an application for a refund of other than *ad valorem* or unconstitutional taxes must be filed within four years of payment. KRS 139.580. However, such time periods may be extended by written agreement between the Department and the taxpayer. While some taxpayers have a policy to not extend the statute of limitations, many will often agree to extend the statute of limitations, provided that the audit is progressing to an anticipated completion.

The Tax Audit

Audits may be either desk audits (literally done at the auditor's desk) or field audits (at the taxpayer's location). If the audit is taking place at the taxpayer's location, the Department must perform its audit at "reasonable times and places." KRS 131.081(3). Tax auditors should be treated with professional courtesy; they are doing their job. Taxpayers should be likewise treated.

Audits are typically commenced with an opening meeting with the taxpayer that may include the auditor's supervisor. Details of the audit process are often discussed.

During a typical audit, the tax auditor will request information and documents from the taxpayer, and the taxpayer will respond to the auditor's requests for information or documents. The exchanges center on the treatment of the transaction or item at issue. For example, in a sales tax audit, the auditor will request copies of resale and exemption certificates or copies of purchase invoices, and the taxpayer will respond with documents and explanations as to why particular transactions are exempt or otherwise not subject to tax. Similar exchanges occur in tangible personal property tax audits, income tax audits, etc.

The auditor will produce an audit narrative that describes the audit including the identity of the taxpayer, the taxpayer's representative, audit type (e.g., sales tax, income tax, etc.), periods examined, statute of limitation waivers, protest period, auditor, review officer, and a description of the items or transactions examined by the audit (e.g., sales, deductions, capital purchases, consumable purchases, etc. in a sales tax audit). The auditor will also produce schedules of items examined and calculations of tax, *i.e.*, audit workpapers.

The Department must ultimately provide a taxpayer with "copies of the agent's audit workpapers and the agent's written narrative setting forth the grounds upon which the assessment is made" as well as the grounds for the denial or reduction of any refund or credit. KRS 131.081(8). Nevertheless, a taxpayer should request a copy of the draft audit workpapers before the end of the audit. The taxpayer should carefully review the audit workpapers to identify any mathematical errors and any items of disagreement.

At the end of each audit, there is typically an informal end of audit meeting with the auditor. The auditor's supervisor may also attend.

Hopefully, the taxpayer, the taxpayer's adviser(s), and the Department will be in agreement after an audit as to the amount of tax; the taxpayer can then either pay the difference, receive a refund for the difference, or do nothing if it is a "no change" audit. However, that is not always the circumstance. Reasonable minds can and do differ as to the construction of the tax laws or the application of the tax laws to the taxpayer's particular facts.

Right to Protest a Tax Assessment

The Department must issue a notice of tax due within the applicable statute of limitations. See, e.g., KRS 139.620 (sales and use tax). The notice of tax due must include "a clear and concise description of the basis and amount of any tax, penalty, and interest assessed against the taxpayer" and copies of the final audit workpapers and audit narrative must be provided to the taxpayer. KRS 131.081(8). Often, as a practical matter, reference to the audit workpapers and audit narrative is necessary to determine the Department's basis for any amounts assessed.

A taxpayer may protest a notice of tax due within 60 days of the date of the notice; otherwise, the assessment becomes final, due and payable. KRS 131.110(1). The protest must be in writing and must also be accompanied by a supporting statement setting forth the grounds upon which the protest is made. KRS 131.110(1)(c). The time for submitting the supporting statement may be extended if the delay is necessary and unavoidable. *Id.* For example, the tax adviser was just retained to represent the taxpayer in the protest. It is very important to not only file the written protest within the 60-day protest period, it is just as important to be able to prove that the protest was filed within that period; so, when filing a protest, chose a delivery method that can readily show timely receipt (e.g., hand delivery, fax, email, delivery service with proof of delivery, etc.).

Ideally, a supporting statement should be compelling. It should set forth the material outcome determinative facts and explain how the law applies to those facts. Such a supporting statement can result in the Department conceding some or all of the issues raised in the protest, particularly when the issue has one clearly “right” answer.

A taxpayer may also request a protest conference with the Department. KRS 131.110(2). A protest conference is an opportunity for the taxpayer to present their case to the Department and to have a dialogue with the Department. Requesting a protest conference often facilitates a resolution of the protest.

Settlement of Gray Tax Issues

Not all tax issues have a right and a wrong answer. It is not all black and white; there is often a scale of shades of gray. Taxpayers and the Department do not have to litigate every issue; indeed, the Department can settle issues. KRS 131.030(3) (“The department shall have all the powers and duties necessary to consider and settle tax cases under KRS 131.110 and refund claims made under KRS 134.580.”). In fact, “The department is encouraged to settle controversies on a fair and equitable basis and shall be authorized to settle tax controversies based on the hazards of litigation applicable to them.” *Id.*

The protest process is a great time to settle tax issues with the Department. Note that settlement is predicated on articulating “hazards of litigation” to the Department. So, it is important to make a compelling case. While a taxpayer may raise the possibility of settlement with the Department, the Department will also often raise the possibility of settlement with a taxpayer; either the taxpayer or the Department may tender an offer of settlement to the other. Oftentimes, this results in a settlement of the tax issue but not always.

Right to Request a Final Ruling

What happens if a taxpayer and the Department do not see eye to eye? Either the Department may signal that it will issue a final ruling or the taxpayer may request a final ruling. If the taxpayer requests a final ruling, the Department must issue the ruling within 30 days. KRS 131.110(4). The taxpayer then has a right to appeal the Department’s final ruling to the Kentucky Board of Tax Appeals (KBTA) by filing a petition of appeal; otherwise, if the taxpayer does not, the assessment becomes final, due and owing. KRS 131.110(5); KRS 49.220.

Right to Appeal to the KBTA

The Department is not infallible, and taxpayers should not be compelled to pay taxes, interest or penalties that are not due. It is thus essential that a taxpayer has a right to appeal to the KBTA, which will review the taxpayer’s appeal *de novo*, *i.e.*, as though it was the first time. KRS 49.220. The KBTA is a three-person administrative adjudicative body that hears tax appeals. KRS Chapter 49. Either the full board or a hearing officer may hear the appeal. *Id.* The KBTA’s rules provide for discovery allowing the parties to “discover” facts and other information relevant to the tax issues before the KBTA using interrogatories (*i.e.*, written questions), requests for production of documents, requests for admissions, and depositions. 802 KAR 1:010. The taxpayer and the Department may “present evidence and argument, conduct cross-examination, and submit rebuttal evidence....” KRS 13B.080(4). The evidence becomes part of the record for judicial appeal. KRS Chapter 13B. Based on one or more motions for summary disposition or an evidentiary hearing, either a hearing officer will issue a recommended order to which exceptions may be taken (if the case is before a hearing officer) or the full board will issue a final order. KRS 13B.110; KRS 13B.120. The KBTA’s final order may be appealed to circuit court. KRS 13B.140; KRS 49.250.

Right to Judicial Appeals

The KBTA is not infallible either, and Kentucky tax statutes recognize this by giving taxpayers (and the Department) a right to appeal to circuit court. KRS 13B.140; KRS 49.250. The circuit court's role is to review the KBTA's final order, essentially functioning as an appellate court. KRS 13B.150. A party aggrieved by a Circuit Court's Opinion in a tax matter may appeal that decision to the state-level Court of Appeals, as a matter of right. But, an appeal from the Court of Appeals is available to the Kentucky Supreme Court or to the United States Supreme Court at their discretion.

Most taxpayers are individuals and small and mid-sized businesses, if they are appealing their tax assessments, it is generally because they have a good faith belief that the taxes assessed are not due. Burdening taxpayers by forcing them to pay the amounts alleged to be due or to post a bond before they have been finally determined by the courts works as a *de facto* deprivation of taxpayers' rights of access to the courts for the purpose of judicially reviewing a tax assessment upheld by the KBTA. Requiring payment or a bond as a prerequisite to appeal tax assessments is referred to as a "pay-to-play" system and is generally considered to be an anti-taxpayer provision. The General Assembly rejected this when it amended KRS 49.250 in 2018 to affirmatively provide, "If the appeal is from an order sustaining a tax assessment, collection of the tax shall be stayed by the filing of a petition or an appeal to any court. Full payment of the tax or a supersedeas bond is not required to appeal an order sustaining a tax assessment." As such, all taxpayers, regardless of size, have similar access to the courts to judicially appeal their tax assessments.

Taxpayer's Right to an Installment Payment

When tax is final due and owing, whether on amounts taxpayers compute as due on their own tax returns or as a result of an audit, that taxpayers cannot pay, taxpayers have a right to an installment agreement. KRS 131.081(9). Oftentimes, facilitating the collection of taxes due the Commonwealth from a taxpayer requires giving that taxpayer time to pay. As recognized in KRS 131.018(9), this happens when a taxpayer demonstrates their inability to pay in full and the installment agreement facilitates collection. As such, it makes sense not just for the taxpayer but also for the Commonwealth that taxpayers should have a right to an installment agreement.

"Just Keep Swimming" Dory in *Finding Nemo* (2003).

Kentucky taxpayers have rights when they are audited that help ensure they pay the right amount of tax. Maintaining these rights is essential to the integrity of Kentucky's tax system. And, as a practical matter, when taxpayers understand and exercise their rights, they are more likely to pay amounts that are actually due.

The foregoing insights were from Mark A. Loyd's regular column, *Tax in the Bluegrass*, appearing the [Kentucky CPA Journal](#).

STATE AND LOCAL TAX TEAM



Mark A. Loyd
Chair, Tax Department
mark.loyd@dentons.com



Bailey Roese
Partner
bailey.roese@dentons.com



Brett J. Miller
Partner
brett.miller@dentons.com



Stephanie Bruns
Managing Associate
stephanie.bruns@dentons.com



Jeffrey T. Bennett
Partner
jeff.bennett@dentons.com



Brad Hasler
Partner
bradley.hasler@dentons.com



Kelli A. Wikoff
Partner
kelli.wikoff@dentons.com



Kimberly M. Nolte
Associate
kimberly.nolte@dentons.com



Gary R. Thorup
Shareholder
gary.thorup@dentons.com



Eric Smith
Of Counsel
eric.smith@dentons.com