

Kentucky Tax Alert

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Gov. Fletcher Announces Structure of Newly Merged Cabinets

In July, Gov. Ernie Fletcher revealed the new organizational structure of the Finance and Administration Cabinet, which includes Revenue and the Commonwealth Office of Technology. Secretary Robbie Rudolph heads the newly merged Finance and Administration Cabinet. Rudolph is president of Rudolph's, Inc., a wholesale tire business located in Murray, Kentucky.

Mark Treesh is the commissioner of the Department of Revenue. Treesh most recently worked as the legislative liaison for the Finance and Administration Cabinet during the 2004 legislative session. Prior to joining Gov. Fletcher's administration, he represented the 14th district in the Kentucky House of Representatives for nearly 10 years. Tim LeDonne is the deputy commissioner of Revenue. LeDonne, former director of Revenue Operations, has a B.S. in mechanical engineering and a master's degree in business administration.

Under the reorganized Finance and Administration Cabinet, the Office of General Counsel (OGC) is under the direction of the Secretary and is headed by Executive Director Michael Kalinyak. The Office of Legal Services for Revenue, which is headed by Executive Director Debra Keelen and the Division of Protest Resolution are also under the OGC.

The Department of Revenue (DOR) now consists of the Office of Taxpayer Ombudsman, Office of Processing and

Enforcement, Office of Property Valuation, Office of Sales and Excise Taxes, Office of Income Taxation, Office of Field Operations and PVA Offices (accounting). There is also a Division of Legislative Services, which is directed by Eddie Mattingly.

David Fallis is the executive director of the Office of Taxpayer Ombudsman.

Mack Gillim is the executive director of the Office of Processing and Enforcement which includes the Division of Operations, the Division of Collections, and the Division of Registration and Data Integrity.

Marian Davis is the executive director of the Office of Property Valuation which includes the Division of Local Valuation, the Division of State Valuation, and the Division of Minerals Taxation and GIS Services.

Richard Dobson is the executive director of the Office of Sales and Excise Taxes which includes the Division of Sales and Use Tax and the Division of Miscellaneous Taxes.

Gary Morris is the executive director of the Office of Income Taxation which includes the Division of Individual Income Tax and the Division of Corporation Tax.

Wayne Byrd is the executive director of the Office of Field Operations which includes three regions and the Audit Support and Training Branch.

The PVA Administrative Support Branch is now part of the Finance and Administration Cabinet's Office of the Controller, Division of Local Government Services.

Kentucky DOR, IRS Sponsor Electronic Filing Seminars

The Kentucky Department of Revenue (DOR) and the Internal Revenue Service (IRS) will sponsor seven seminars on electronic filing of individual income tax returns at various sites across the state. Each seminar runs from 9:00 a.m. to 4:30 p.m. local time.

The morning session (9:00-11:30) is geared to practitioners who are new to e-file; however, those new to the program would also benefit from attending the afternoon session (12:30-4:30). Topics covered by the IRS and DOR benefit new e-filers as well as those who have participated previously. A representative of the Indiana Department of Revenue is attending the seminar in Louisville and Owensboro.

Registration is necessary as space is limited. Registration also helps the DOR and IRS plan the seminars. Registration forms are being mailed to Kentucky EROs by the IRS in late September. If you do not receive this form, please contact Judy Ritchie at the Kentucky DOR at (502) 564-5370 for a registration form.

Seminars will be held at the following locations:

Oct. 19, Alexandria

Northern Kentucky University
Rooms 115-117 Nunn Dr
Highland Heights, Ky 41099

Oct. 27, Prestonsburg

Jenny Wiley State Park
75 Theatre Court
Prestonsburg, KY 41653

Nov. 3, Lexington

Lexington Public Library
Theatre-First Floor
140 East Main St.
Lexington, KY 40507

Nov. 9, Louisville

Jefferson Community College
SW Campus Auditorium
1000 Community College Dr.
Louisville, KY 40272

Dec. 1, Paducah

West Ky Community and
Technical College
Crouse Hall, Room 101
4810 Alben Barkley Dr.
Paducah, Ky 42002

Dec. 2, Bowling Green

Western Kentucky University
Carroll Knicely Conference Center Room 163B
2355 Nashville Rd.
Bowling Green, KY 42101

Dec. 17, Owensboro

Owensboro Community and Technical College
Southeastern Campus, Industry Room
1901 Southeastern Pkwy. (behind Daviess Co. HS)
Owensboro, KY 42303

2004 UK Income Tax Seminar Schedule

The University of Kentucky's College of Agriculture announces the 2004 Income Tax Seminar Schedule. Registration brochures were sent in August. Tuition remains \$199, which includes all books. Registration began Sept. 15, 2004. Sixteen hours of CPE will be provided for completion of the course. For more information, contact (888) 808-3303 or (859) 252-3769 or visit the Web site (www.uky.edu/Ag/AgEcon/taxwkshp.html).

Schedule for the 2004 Income Tax Seminar:

Nov. 3-4	Somerset
Nov. 8-9	Jenny Wiley
Nov. 9-10	Frankfort
Nov. 15-16	Lexington #1
Nov. 16-17	Louisville
Nov. 17-18	Maysville
Nov. 22-23	Northern Kentucky #1
Nov. 22-23	Hopkinsville
Nov. 29-30	Grayson
Nov. 30-Dec. 1	Owensboro
Dec. 2-3	Bowling Green
Dec. 6-7	Paducah
Dec. 7-8	Lexington #2
Dec. 9-10	Elizabethtown
Jan. 5-6, 2005	NEW!!
	Northern Kentucky #2

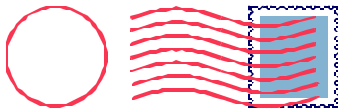
State Real Property Tax Rate Set



The 2004 state real property tax rate is set at 13.1 cents per \$100 of assessed valuation. Under House Bill (HB) 44 the rate is reviewed each year and adjusted to ensure that no more than a 4 percent cumulative increase in revenues is realized over the previous year. Before enactment of HB 44 in 1979, the state rate was 31.5 cents per \$100 of assessed valuation.

The establishment of the 2004 state real property tax rate enables those counties certified by DOR to proceed with tax bill preparation once the local rates are set.

Update Address and Routing Numbers

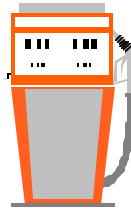


Each year over 6,000 refund checks are returned to the Department of Revenue (DOR) with incorrect or incomplete addresses. The most common reasons include outdated information, incomplete street addresses and the omission of apartment numbers. In addition to returned mail, almost 2,000 direct deposit refunds cannot be processed due to incorrect or outdated routing number information. These refunds are subsequently issued as “paper refunds.”

The DOR expends an enormous amount of time and money researching databases in an attempt to deliver these refunds to the intended recipients. Time and resources used on these issues could be better utilized serving Kentucky’s taxpayers in other areas.

Please take time during this tax season to review and update your client’s addresses and banking information. Include apartment numbers when appropriate and, whenever possible, provide daytime telephone numbers for contact. The minutes you take verifying this information up front will ensure that your client’s refunds are received in a timely manner.

Gasoline Excise Tax Rate



Under KRS 138.210 and 138.220, the Department of Revenue (DOR) is responsible for establishing the average wholesale price (AWP) of gasoline for the purpose of calculating the gasoline excise tax rate.

The current price calculation is based on sales data accumulated for the month of July 2004 and a grade and formulation weighted average reflecting gasoline consumption patterns.

For the quarter commencing Oct. 1, 2004, the DOR has determined the AWP of gasoline remains \$1.22. Therefore, the rate remains 17.4 cents per gallon for gasoline and 14.4 cents per gallon for special fuels and is inclusive of the 1.4 cent Petroleum Storage Tank Environment Assurance Fee. Additionally, the rate for liquefied petroleum remains at 16.0 cents per gallon.

Kentucky Tax Alert is a bimonthly publication printed on recycled paper, the cost of which is paid from state funds. Comments, suggestions and mailing list additions or corrections should be addressed to the Office of Public Information, Finance Secretary’s Office, Frankfort, Kentucky (502) 564-4240.

ERNIE FLETCHER, Governor

**ROBBIE RUDOLPH, Secretary
Finance and Administration Cabinet**

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The Department of Revenue can be found at www.revenue.ky.gov.

Court Case Updates



Corporation Income Tax-

On July 1, 2004, the Franklin Circuit Court entered an opinion and order in *Johnson Controls Inc. v. Revenue*

Cabinet, 00-CI-00523 and 00-CI-00661 ruling that HB 541 enacted by the 2000 General Assembly was constitutional. The plaintiffs in this case were corporate taxpayers that had originally reported and paid their corporation income tax liability on a separate return basis. They subsequently sought tax refunds by filing amended combined corporation income tax returns employing the unitary business concept.

HB 541 presented an obstacle to the plaintiffs' refund claims, however. This legislation amended the corporation income tax statutes to bar 1) corporation income tax refund claims based on combined unitary or consolidated returns filed after Dec. 22, 1994, for tax years ending on or before Dec. 31, 1995, and 2) corporations from filing combined unitary or consolidated returns for tax years ending before Dec. 31, 1995, unless the corporations had filed combined unitary or consolidated returns on or before Dec. 22, 1994, for tax years ending before Dec. 22, 1994. KRS 141.200(9) and (10); 2000 Ky. Acts, Ch. 543 §1. This legislation applied to bar the plaintiffs' refund claims.

The plaintiffs challenged HB 541 on a variety of constitutional grounds, all of which were rejected by the circuit court in its July 1, 2004, opinion and order.

The first constitutional claim addressed by the circuit court was the plaintiffs' contention that HB 541 violated the Due Process Clause of the United States Constitution. The court observed the "[w]ithout cavil, [House Bill] 541 retroactively prohibits the filing of unitary returns for pre-1995 years after December 22, 1994, unless the corporate group filed such a return on or before December 22, 1994." The court stated that the prevailing constitutional test for the validity of retroactive tax legislation had been set forth in *United States v. Carlton*, 512 U.S. 26 (1994). Under that test, retroactive legislation will be upheld if it is supported by a legitimate legislative purpose furthered by rational means.

The circuit court held that HB 541 satisfied this test. The rational legislative basis for HB 541 was the avoidance of a massive loss of state revenue

resulting from corporations' reliance upon the Kentucky Supreme Court's Dec. 22, 1994, decision in *GTE v. Revenue Cabinet*, Ky., 889 S.W.2d 788 (1994) to file unitary returns seeking refunds for pre-1995 tax years.

The circuit court rejected the plaintiffs' argument that they were being penalized for their detrimental reliance upon the DOR's interpretation of prior law. The court pointed out that *Carlton* makes it clear that detrimental reliance alone is insufficient to make out a constitutional violation and that taxpayers have no vested rights in the tax laws.

The court also rejected the plaintiffs' contention that the period of retroactivity was excessive. No such requirement was imposed by the majority opinion in the *Carlton* decision. In any event, HB 541's period of retroactivity (at most 5.5 years) was not excessive given its legitimate governmental purpose of stemming the loss of massive revenue that would be caused by allowing corporations to file unitary corporation income tax returns for pre-1995 years and in light of the retroactivity periods approved in many federal court decisions.

The circuit court next considered and rejected the plaintiffs' Equal Protection Clause claim. To satisfy this constitutional provision, any distinction made by HB 541 needed only to be rationally related to a legitimate state objective. The court held that HB 541 met this constitutional test. HB 541 set an effective date of Dec. 22, 1994, for the use of combined unitary corporation income tax returns and treated "similarly situated taxpayers" differently on either side of this date. This legislation constituted "a rational means of accomplishing the legitimate public purpose of avoiding the loss of tax revenue" and thus was constitutional under the Equal Protection Clause.

The plaintiffs also relied upon sections 2 and 3 of the Kentucky Constitution in support of their equal protection and due process claims. The circuit court found "no significant difference" between these state constitutional claims and the federal constitutional claims and accordingly rejected them for the same reasons.

The plaintiffs next asserted that HB 541 constituted special legislation in violation of Ky. Const. §59. The circuit court found this claim to be unpersuasive and rejected it. The court held that

Court Case Updates (cont.)

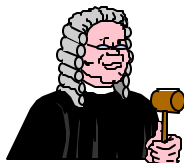
HB 541 satisfied the prevailing two-part test enunciated by this state's highest court in *Schoo v. Rose*, Ky., 270 S.W.2d 940, 941 (1954) - - "(1)[the legislation] must apply to all in a class, and (2) there must be distinctive and natural reasons inducing and supporting the classification." HB 541 "applie[d] equally to all corporations seeking to file pre-1995 'unitary' or 'combined' tax returns after December 22, 1994, and it applie[d] equally to all corporations that filed their pre-1995 'unitary' or 'combined' tax returns on or before December 22, 1994."

The circuit court further pointed out that the second prong of the Schoo test essentially amounts to the rational basis test governing the plaintiffs' equal protection and due process claims. In this case, there was a rational basis and "valid nexus" between the Dec. 22, 1994, cut-off date for unitary returns and the legitimate purpose of avoiding a massive loss of state revenue due to unitary refund claims.

In addition, the plaintiffs argued that HB 541 violated state and federal constitutional provisions prohibiting the taking of private property for public use without just compensation. The circuit court found no legal authority to support this claim. The plaintiffs failed to identify any particular property right of theirs being taken and to the contrary, "case law holds that taxpayers do not have property rights in the tax code." The circuit court accordingly rejected this claim.

Finally, the circuit court turned away the plaintiffs' claim that HB 541 "invade[d] the power of the judicial and executive branches in violation of the separation of powers doctrine in Sections 27 and 28 of the Kentucky Constitution." The circuit court ruled that HB 541 did not affect the court's judgment in the *GTE v. Revenue Cabinet* case. Instead, HB 541 amended the statutory structure analyzed in *GTE* and this measure was within the constitutional power and responsibility of the General Assembly to tax and spend the public's money.

The circuit court's July 1, 2004, opinion and order is not yet final. The plaintiffs have appealed this decision to the Kentucky Court of Appeals and are in the process of seeking a transfer of this appeal to the Kentucky Supreme Court.



Corporation License Tax—On July 8, 2004, the Franklin Circuit Court entered an opinion and order in *Citizens National Corporation v. Rudolph*, 03-CI-00817, deciding that former Gov. Patton's partial veto of HB 390, enacted by the 2003 General Assembly (2003 Ky. Acts, Ch. 194), was invalid.



HB 390 was originally an act that related to the enforcement of the Tobacco Master Settlement Agreement. In one of the original bill's 17 sections, \$175,000 was appropriated to the Revenue Cabinet to carry out the provisions of KRS 131.600, 131.602 and other sections of the bill.

The bill was passed by the House and sent to the Senate. In the latter part of the 2003 legislative session, a Senate committee created a substitute for HB 390 that added three sections, all relating to the corporation license tax benefit that had been formerly allowed by KRS 136.071. The Franklin Circuit Court had previously held in the case of *Illinois Tool Works v. Revenue Cabinet*, 00-CI-623 that KRS 136.071 was unconstitutional finding that it discriminated against interstate commerce in violation of the United States Constitution's Commerce Clause.

The sections added to HB 390 by the Senate committee substitute repealed KRS 136.071. 2003 Ky. Acts, Ch. 194 §19. They also restored most of the corporation license tax benefit formerly bestowed by KRS 136.071. *Id.* at §15. The restoration of this corporation license tax benefit was of short duration, however. It was "effective for tax periods for which a corporation license tax return [was] due, without regard to extension, on or after April 15, 2004," but it did not apply "to any tax period for which a corporation license tax return [was] due, without regard to extension, on or after April 15, 2005." *Id.* at §18. All of the corporation license tax provisions added by the Senate to HB 390 were vetoed by former Gov. Patton on April 3, 2003. The remaining provisions of this bill became law without his signature.

The circuit court's July 8, 2004, opinion and order finds that former Gov. Patton's partial veto could not be sustained under the authority bestowed upon him by Ky. Const. §88, which states that "[t]he

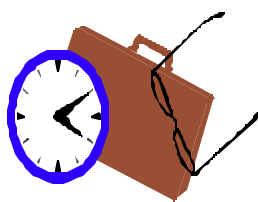
Court Case Updates (cont.)

Governor shall have the power to disapprove any part or parts of appropriation bills embracing distinct items, and the part or parts disapproved shall not become a law unless reconsidered and passed, as in case of a bill.” The circuit court holds that HB 390 was not an “appropriation bill” within the meaning of this constitutional provision.

The circuit court further rules in this opinion and order that former Gov. Patton’s partial veto violated the separation of powers expressed in Kentucky Constitution §28. The court reasons that an interpretation of Kentucky Constitution §88 sustaining this partial veto would give the governor an “excessive amount of legislative power” in violation of Kentucky Constitution §28. Recognizing that the partial veto power conferred upon the governor by Kentucky Constitution §88 serves an important purpose of preventing legislative log-rolling, the court is nevertheless “more troubled about substantial changes in the distribution of power among the branches” of government.

Finally, the circuit court rejects the DOR’s contention that the vetoed provisions of HB 390 were invalid under Ky. Const. §47, which requires that “[a]ll bills for raising revenue... originate in the House of Representatives.” The court accordingly rules that HB 390 was not covered by this constitutional provision because its primary purpose was not to raise revenue.

This decision is not final. The DOR has taken an appeal to the Kentucky Court of Appeals. The corporations challenging former Gov. Patton’s veto in this case (Citizen’s National Corporation, Humana, Inc., Kindred Healthcare, Inc., LG&E Energy Corporation, and Yum! Brands, Inc.) have moved to transfer this appeal to the Kentucky Supreme Court.



Individual Income Tax—

On May 21, 2004, the Franklin Circuit Court affirmed a KBTA decision in DOR’s favor in the individual income tax case of *Kolak v.*

Revenue Cabinet, 99-CI-00683.

The taxpayer was an employee of the Internal Revenue Service (IRS) from 1959 to 1995. During his career, he accumulated 1,631 hours of unused annual leave while working for the IRS in

several states. The taxpayer ended his IRS career in Kentucky and upon his retirement received a lump sum payment of \$86,997.54 as compensation for his accrued unused annual leave. Of this lump sum payment, \$82,036.92 represented unused annual leave hours accrued by the taxpayer before becoming a Kentucky resident. However, the taxpayer received the entire lump sum payment while a Kentucky resident. He moved to another state after receiving that payment.

The circuit court rejected the taxpayer’s argument that Kentucky’s subjecting the entire lump sum payment to its income tax was unconstitutional. The court cited prior judicial precedent for the “universally recognized” rule that a resident’s receipt of income is taxable by the “taxing sovereignty” in which he resides. It was undisputed that the taxpayer received the entire lump sum payment while a Kentucky resident.

In addition, KRS 141.050(1) required that federal income tax accounting methods apply in the computation of the Kentucky income tax in this case. The taxpayer utilized the cash method of accounting, which required that he include in his gross income all items actually or constructively received during the year in question. This meant that the entire \$86,997.54 lump sum payment was subject to Kentucky income tax for the year it was received by the taxpayer while a Kentucky resident.

No appeal was taken by the taxpayer. This decision is therefore now final.



Sales and Use Tax—On April 15, 2004, the Kentucky Supreme Court denied the taxpayer’s motion for discretionary review in *D.C. Contracting Co. v. Revenue Cabinet*, 2003-SC-0351. This action renders final an earlier opinion of the Court of Appeals in the DOR’s favor.

The taxpayer was a contractor performing work on the closure of a chlor-caustic waste lagoon that was part of an overall clean-up of an industrial site ordered by the U.S. Environmental Protection Agency. As a contractor, its purchases of tangible personal property for use in the performance of its work, as pointed out in 103 KAR 26:070, are subject to sales and use tax. The contractor did not pay tax on its purchases for the chlor-caustic lagoon

Court Cases Update (cont.)

project and was accordingly assessed sales and use tax by the DOR.

The taxpayer contended that the purchases in question were exempt from tax under the pollution control facility exemption now codified at KRS 139.480(12). Agreeing with previous decisions of the KBTA and the Franklin Circuit Court, the Court of Appeals in its opinion rendered on April 11, 2003, held that the taxpayer could not qualify for the exemption because it had not applied for or obtained a pollution control tax exemption certificate, as required by KRS 139.480(12) and 224.01-310. The statutory language requires that this exemption certificate be applied for before making the purchases for which the exemption is to be claimed.

The Court of Appeals rejected the taxpayer's argument that it should receive the benefit of the exemption anyway, because the DOR had not promulgated a regulation on this subject. The language of KRS 224.01-310(1) relied upon by the taxpayer ("in such form as may be prescribed by regulations issued by the Revenue Cabinet") did not mandate the promulgation of a regulation, by virtue of its use of the permissive term *may*. See KRS 446.010(20). Moreover, the requirement of an application for a pollution control tax exemption certificate was unambiguously set forth in the statutory language itself, rendering a regulation concerning this facet of the exemption unnecessary.



Sales and Use Tax—On April 22, 2004, the Kentucky Supreme Court rendered an opinion in *Popplewell's Alligator Dock No. 1 v. Revenue Cabinet*, 2001-SC-0434 and 2001-SC-0439. This case consisted of two appeals presenting the substantive question

of the application of a sales and use tax exemption, KRS 139.483, and the procedural question of whether a taxpayer was required to exhaust its administrative remedies before it could proceed to court for injunctive and declaratory relief based upon this substantive issue. The Supreme Court ruled in the DOR's favor on both issues.

The facts were undisputed. Popplewell's Alligator Dock, Inc. ("Alligator Dock") operated a marina on Lake Cumberland in Russell County, Kentucky. As part of its retail business, it rented luxury

houseboats to the public for recreation and vacation purposes. A person renting a houseboat took possession of it with a full tank of gasoline and was required to return it at the conclusion of the rental term with a full tank of gasoline.

If, upon the houseboat's return, the gasoline tank was not full, Alligator Dock's employees would refill it and the renter of the houseboat was charged an additional amount for the gasoline. Alligator Dock did not collect tax on these gasoline sales and was accordingly assessed tax by the Cabinet. (As the Supreme Court points out in footnote three of its opinion, the use tax applies to these gasoline sales instead of the sales tax that would ordinarily apply to in-state sales of tangible personal property. This result follows from the language of the sales and use tax statutes specifically applicable to this subject. See *Commonwealth ex rel. Ross v. Lee's Ford Dock, Inc.* Ky. 551 S.W.2d 236 (1977); KRS 139.500(2); 1990 Ky. Act, Ch. 414 § 3.)

Alligator Dock protested its assessment to the DOR in accordance with KRS 131.110 and 103 KAR 1:010. It ultimately received a final ruling that it appealed to the KBTA. In its appeal, Alligator Dock asserted that its gasoline sales were exempt from tax under KRS 139.483, which states that sales and use tax "shall not apply to the sale of, or the storage, use, or other consumption of, ships and vessels, including property used in the repair or construction of, supplies and fuel consumed in the operation of, and supplies consumed by crew members aboard such ships and vessels which are used principally in the transportation of property or in the conveyance of persons for hire."

Shortly before Alligator Dock filed its appeal with the KBTA, another marina operator conducting business in essentially the same manner (State Dock, Inc.) filed suit in the Franklin Circuit Court against the DOR, seeking a judicial declaration that KRS 139.483 exempted its houseboat rentals as well as a permanent injunction prohibiting DOR from assessing or attempting to collect sales tax on those houseboat rentals. Alligator Dock later intervened in this case (the *State Dock* case) and eventually, an amended complaint was filed by both taxpayers contending that both the houseboat rentals and gasoline sales were exempt from tax under KRS 139.483.

Court Case Updates (cont.)



The DOR moved to dismiss the *State Dock* case for lack of subject matter jurisdiction and the taxpayers' failure to exhaust administrative remedies. The circuit court granted this motion and dismissed the case. The taxpayer appealed this decision to the Court of Appeals.

Meanwhile, the KBTA ruled in the DOR's favor on Alligator Dock's tax appeal, holding that KRS 139.483 did not apply to the gasoline sales in question. Alligator Dock appealed the KBTA's decision to the Franklin Circuit Court, which affirmed that decision.

Alligator Dock appealed the circuit court's decision to the Court of Appeals. This appeal was consolidated with the appeal in the *State Dock* case. The Court of Appeals rendered an opinion ruling, as the KBTA and Franklin Circuit had, that KRS 139.483 did not apply to Alligator Dock's gasoline sales. However, the court reversed the circuit court's decision in the *State Dock* case, holding that exhaustion of administrative remedies was not required because the facts were not in dispute and the issue was thereby confined to a legal one of the applicability of a statute.

Both parties sought discretionary review by the Kentucky Supreme Court, which was granted and culminated in the Supreme Court's April 22, 2004, opinion.

The Supreme Court upheld the Court of Appeals on the question of KRS 139.483's application. The court held that this exemption "is restricted to vessels used principally: (1) 'in the transportation of property,' and (2) 'in the conveyance of persons for hire.'" "[T]he houseboats [in question] were not used principally for either purpose; they were used principally to provide lodging to vacationers and for their recreational purposes." The court noted that "[a]ny transportation of property was extremely insignificant and, like any conveyance of persons accomplished, was ancillary to the primary purposes of lodging and recreation" served by the houseboats.

The Supreme Court rejected Alligator Dock's argument that this case was controlled by a prior decision of the Court of Appeals, *Barnes v. Department of Revenue*, Ky. App., 575 S.W.2d 169 (1978). The law had changed significantly since

Barnes. Moreover, the court found that the *Barnes* decision was erroneous and its reasoning flawed.

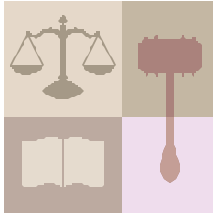
The Supreme Court also rejected Alligator Dock's contention that denial of the exemption would result in a violation of the equal protection provisions of the state and federal constitutions. The court held that a statutory classification will withstand equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification. The court agreed with the DOR that a rational basis existed for the distinction in question: the General Assembly could reasonably have viewed houseboats and other recreational vessels as playing a different role in the economy and operating in a different competitive market or environment than ships and vessels used principally in the transportation of property or conveyance of persons for hire. Furthermore, the latter types of vessels could reasonably have been viewed by the General Assembly "as creating more-and-better-paying jobs than recreational vessels." Thus, the Supreme Court found that the reasons for the legislative classification assailed by Alligator Dock were at least plausible and accordingly concluded that KRS 139.483 was constitutional.

The Supreme Court reversed the Court of Appeals' ruling in the *State Dock* case and reinstated the circuit court's dismissal of the taxpayers' original action for declaratory and injunctive relief. The court held that a taxpayer must demonstrate that the administrative remedy is inadequate or would be an exercise in futility before it can proceed directly to circuit court for relief. In this case, the taxpayers had an adequate administrative remedy available to them, which they were required to pursue. Additionally, the mere presence of a constitutional issue will not excuse a party's failure to exhaust administrative remedies prior to seeking judicial review of an as-applied constitutional challenge.

These previous decisions suggested that exhaustion would not be required—that is, the administrative process would amount to "an exercise in futility"—only when the issue in the case was the constitutionality of a statute or regulation on its face.

The Kentucky Supreme Court's decision in this case is now final.

Court Case Updates (cont.)



Sales and Use Tax—On June 17, 2004, the Kentucky Supreme Court rendered an opinion in the sales and use tax case of *LWD Equipment, Inc. v. Revenue Cabinet*, 2002-SC-0329-DG and 2003-SC-0318-DG. Two issues were decided—the substantive

question of the application of the sales and use tax exemption provided for in KRS 139.470(4) and 139.070(1)(b) for occasional sales and a procedural question of whether the KBTA must be made a party to appeals from its decisions to the circuit court.

The taxpayer LWD Equipment, Inc. was a wholly owned subsidiary of LWD Holding, Inc. LWD Holding was the sole owner of a number of other corporations in addition to LWD Equipment.

LWD Equipment's sole function was to acquire a variety of equipment—from industrial to office — needed by its sister corporations (i.e., those corporations 100 percent owned by LWD Holding) and to lease that equipment immediately after purchase to the sister corporation needing it. This leasing activity was engaged in by LWD Equipment on a repeated, continuous and ongoing basis. It did not sell or lease equipment to anyone other than its sister corporations. LWD Equipment did not report and pay sales tax on these leases to its sister corporations and was accordingly assessed approximately \$174,000 in sales tax.

LWD Equipment asserted that these leases were exempt occasional sales as defined in KRS 139.070(1)(b). It contended that each lease was a “transfer of all or substantially all the property held or used by [LWD Equipment] in the course of “an activity for which it was required to hold a seller’s permit” and that after each transfer, the real or ultimate ownership of the leased property was substantially similar to that which existed before the transfer. Essentially, LWD Equipment advocated disregarding LWD Equipment’s other ongoing leases of equipment in applying this exemption.

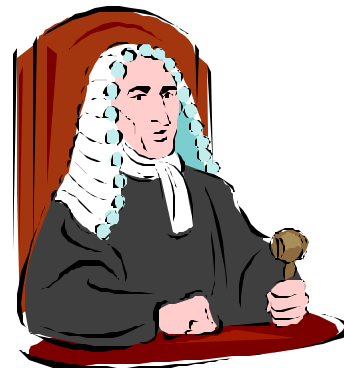
In its June 17, 2004, opinion, the Kentucky Supreme Court ruled that the occasional sale exemption did not apply in this case. The court reaffirms that “[e]xemptions from taxation are generally disfavored and all doubts are resolved against the exemption.” LWD Equipment’s interpretation of the occasional sale exemption would “exempt com-

pletely from taxation items leased.” A lessor could claim first that its initial purchase of an item to be leased was not subject to tax as a purchase for resale under 103 KAR 28:051 §1(3) and then assert that the subsequent lease of the item was an exempt occasional sale, regardless of whether the lessor was otherwise engaged in multiple leases on a continuous and ongoing basis. Under this theory, the court observed, “[a]ny business operation could simply set up a holding company to avoid all sales and use taxes on its equipment.”

Accordingly, the Kentucky Supreme Court could not “accept the interpretation by LWD [Equipment] of KRS 139.070(1)(b) so as to apply the occasional sale exemption to the multiple, continuous, and ongoing leasing activities in this case.” The court further stated that “[t]he General Assembly has not redefined ‘occasional’ so as to give it a particular legal meaning that somehow includes transactions that occur frequently and continuously for several years” and that to follow LWD Equipment’s interpretation “would make the statute unreasonable and produce an absurd result.”

Finally, the Supreme Court held that LWD Equipment’s appeal to the Franklin Circuit Court from the KBTA decision adverse to it did not have to name the KBTA as an indispensable party. The statute governing appeals from the KBTA to the circuit court was KRS 13B.140(1) and that statutory provision was satisfied in this case. Specifically, LWD Equipment’s “petition of appeal to the circuit court named the [KBTA] twice and included the [KBTA’s] address” and the KBTA was served with a copy of the petition.

The Kentucky Supreme Court’s decision in this case is now final.



Court Cases Update (cont.)

Sales and Use Tax—On Aug. 18, 2004, the Kentucky Supreme Court denied the taxpayer's motion for discretionary review in *Morton Buildings, Inc. v. Revenue Cabinet*, 2003-SC-0625.

The Supreme Court's action renders the July 25, 2003, opinion of the Kentucky Court of Appeals in this case final. In that opinion, the Court of Appeals ruled that the taxpayer was subject to use tax for materials it purchased outside Kentucky and used to make building components eventually assembled into prefabricated buildings in Kentucky. That court rejected the taxpayer's arguments that use tax could not apply to the materials because they were purchased and used in manufacturing outside Kentucky and the taxpayer had not specifically intended to use the materials in Kentucky.

The Court of Appeals observed that the purpose of the use tax is to act as a backstop to the sales tax because it ensures that transactions in other states are treated just as if they had taken place in this state and been subjected to the sales tax. The use triggering the use tax's application is broadly defined as "the exercise of any right or power over tangible personal property." In this case, the materials in question, in their altered form, were actually used in Kentucky when the taxpayer assembled the building components made up of the materials into prefabricated buildings.

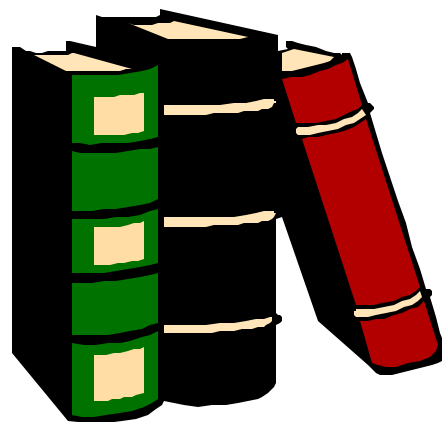
The taxpayer did substantial business in Kentucky, maintaining Kentucky sales offices to sell the prefabricated buildings and constructing at least 700 buildings during the four-year period that was the subject of this case. It was not necessary that the taxpayer knew which particular items ("which two-by-four or bracket") would be used in constructing a specific building in Kentucky in order for the tax to apply.

Moreover, the application of the use tax in this case was supported by 103 KAR 26:070 §6, which states: "In the event any contractor, subcontractor, builder, or contractor/retailer is the manufacturer of the building material or supplies he uses in his construction business, the tax shall apply to the sales price to him of all tangible personal property which enters into the manufacture of such materials or supplies."

The Court of Appeals rejected the taxpayer's argument that 103 KAR 26:070 "unlawfully enlarge[d] the scope of KRS 139.310," the use tax statute. The court relied upon its previous opinion in *Pete Koenig Co. v. Department of Revenue*, Ky. App., 655 S.W.2d 496 (1983) in the holding that this regulation "represented a proper and reasonable clarification of KRS 139.310." Thus, "[p]ursuant to KRS 139.310, as interpreted by 103 KAR 26:070 §6, the raw materials were used in Kentucky by virtue of their incorporation into realty located in Kentucky as part of the structure that is erected by [the taxpayer]."

The Court of Appeals further rejected the taxpayer's assertion that the KBTA and Franklin Circuit Court "improperly ignored decisions from courts of other jurisdictions." The court observed that "Kentucky law is very clear that '[i]n construing a statute, text book authority and cases from other jurisdictions, although informational and persuasive, are not decisive.'"

Finally, the Court of Appeals held that the KBTA's reference to inadmissible evidence in its order was harmless error that did not require reversal. The admissible evidence in the record clearly supported the decisions of the KBTA and the circuit court and the KBTA made no reference to any inadmissible evidence in arriving at its final conclusion.



Frequently Asked Questions for the Office of the Taxpayer Ombudsman

1. How may the Office of the Taxpayer Ombudsman be contacted?

In writing:

Kentucky Department of Revenue (DOR)

Office of the Taxpayer Ombudsman

P. O. Box 930

Frankfort, KY 40602-0930

Telephone Inquires:

502-564-7822 (Toll)

502-564-3058 (TDD - Telecommunication Device for Deaf)

Fax: 502-564-8296

E-mail: KRCWEBResponseOmbud@ky.gov

200 FAIR OAKS LANE

FRANKFORT, KY 40602

Hours of Operation:

Office Hours are Monday-Friday 8:00 AM - 4:30 PM EST

Fax and e-mail available 24 hours a day



2. Who are we?

The Office of the Taxpayer Ombudsman was established in 1990 for the purpose of advocating for the taxpayer by resolving tax issues and recommending system and legislative changes that may identify problems and possibly prevent similar occurrences in the future. [KRS 131.071]

3. Who may use the Office of the Taxpayer Ombudsman services?

If you have an ongoing issue with the DOR that has not been resolved through normal processes, or you have suffered, or are about to suffer a significant hardship as the result of the administration of tax laws, contact the Office of the Taxpayer Ombudsman.

4. What information should I provide to the Office of the Taxpayer Ombudsman?

You should provide copies of any and all information you feel is pertinent to resolving your issue.

5. What can I expect from the Office of the Taxpayer Ombudsman?

Your matter will be assigned to a staff person in the office who will listen to your point of view and will work with the DOR on your behalf to address your concerns.

Reminders

Electronic Return Originators do not need to mail a paper return when the tax liability is being paid, but should submit payment with the 740-V, Kentucky Electronic Payment Voucher.

Tax preparers of Kentucky Corporation Income tax returns need to indicate in the appropriate box if no packet is required for 2004 tax year.

UL Tax Institute Dates

The annual Louis A. Grief Tax Institute will be held on December 15-17, 2004 at the University of Louisville College of Business and Public Administration. Brochures will be mailed the first of November. Please call (502) 852-5847 for more information.

