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Kentucky Law Survey: Kentucky Taxation

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Kentucky Taxation

By FREDRICK W. WHITESIDE, JR.,* & EDWARD J. BUECHEL**

The attention attracted by the massive changes of the 1976 Federal Tax Reform Act has somewhat overshadowed numerous changes in Kentucky's tax law during the past survey year. The cumulative effect of these changes, however, makes 1976 an important year for the commonwealth's tax system. As is usually the case in a legislative year, the impact of new legislation was more significant than judicial decisions, which, though important from the point of view of the parties affected, do not drastically alter the commonwealth's tax structure. The primary changes involved inheritance, property, sales and income taxation, in addition to the coal severance tax. There were also housekeeping and procedural changes.

I. INHERITANCE TAX

The 1976 General Assembly raised the inheritance tax exemption for property going to a decedent's surviving spouse to \$20,000.¹ This applies whether the spouse receives the decedent's property through will or intestacy. For decedents dying prior to June 19, 1976, the exemption was \$10,000 for property going to a surviving wife and \$5,000 for that received by a husband. The new law, therefore, not only raises the exemption, but eliminates the double standard. The exemptions for property going to others remain the same.²

II. COAL SEVERANCE TAX

The only major increase in tax rates involved the coal severance tax. New legislation boosted the rate from 4 to 4.5 percent and raised the minimum tax on coal severed during the reporting period from 30 cents per ton to 50 cents.³ Somewhat

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¹ Ky. Rev. Stat. § 140.080 (Supp. 1976) [hereinafter cited as KRS].

² *Id.*

³ KRS § 143.020 (Supp. 1976). The legislature also continued to provide direction for the spending of the severance tax revenues. *See, e.g.*, KRS § 175.640 (Supp. 1976); Ky. Acts ch. 338, § 3 (1976).

offsetting this increase, however, was another enactment which prohibits counties and other local governments from levying any "occupational, license, excise, severance or other tax . . . upon the severance, processing, sale, use, transportation, or other handling of coal within the commonwealth" This law lays to rest the constitutional issue of the counties' ability to impose franchise taxes on coal.⁵

Though not changed by the legislature, Kentucky Revised Statutes § 42.300 [hereinafter cited as KRS] will be affected by court interpretation. This section provides that the revenue from the state's coal severance tax should be apportioned back to the counties in a "ratio of the severance tax collected in a county to the total amount of severance tax collected statewide."⁶ In *Clay County v. Leslie County*,⁷ the Kentucky Supreme Court affirmed the lower court's holding that severance occurs in the county below which the coal seam lies. In this case the seam was within the boundaries of Leslie County although the mouth of the mine was located in Clay County. Because the coal was in Leslie County, the severance was held to have occurred in Leslie, even though the coal was brought to the surface, weighed, and processed in Clay County. Leslie County, and not Clay, was, therefore, entitled to the revenues derived from the statutory allocation.

III. SALES AND USE TAX

Numerous minor changes were made in Kentucky's sales tax statute,⁸ but only those affecting horses, coal, and sales to charities and governmental units will be discussed herein. As pointed out in last year's survey,⁹ the Kentucky Revenue De-

⁴ KRS § 143.100 (Supp. 1976). This naturally does not affect the state's ability to enact such taxes. *Id.* See also Vance, *State's Take-over of Unmined-coal Tax Is Costing Counties*, *The Courier-Journal & Times* (Louisville), Feb. 13, 1977, § A, at 1, col. 1.

⁵ *C.C.C. Coal Co., Inc. v. Pike County*, 536 S.W.2d 467 (Ky. 1976). In this case the Kentucky Supreme Court held that Pike County's franchise tax on coal was unconstitutional. The county intended to use the tax for road and bridge maintenance, but the Court stated that it was an excise tax which could not be constitutionally levied by a county government.

⁶ KRS § 42.300(2) (Supp. 1976).

⁷ 531 S.W.2d 524 (Ky. 1976).

⁸ KRS §§ 139.010 *et. seq.* (1970), *as amended* (Supp. 1976).

⁹ Whiteside, *The Kentucky Law Survey-Kentucky Taxation*, 64 Ky. L.J. 371, 376 (1976).

partment had extended the statutory exemption provided for the sale of livestock whose products are used for human consumption¹⁰ to include the sale of mares and stallions used in the racehorse industry. Thus, horse sales were due for legislative action. The 1976 General Assembly met the challenge by adopting KRS § 139.531, which specifically provides that sales and use taxes are applicable to fees paid for breeding, the claiming price of any horse claimed at a race within the state, and a horse's sale price unless the sale is otherwise excluded. The statute, however, also states that these taxes will not be collected on sales of horses purchased only for breeding, stallion services used by the owner, sales to non-Kentucky residents when the horses are under 2 years of age, and boarding and training receipts when the horse is temporarily within the state for racing, exhibition, or performing.¹¹

Sales tax exemptions were also provided for the first \$500 received per year from yard or garage sales of household items. These sales are exempt, however, only when unrelated to the operation of a business and conducted by individuals or families, and then only if something less than a substantial amount of an individual's household items are offered for sale. This provision also annually exempts the first \$500 received from events sponsored by nonprofit organizations where these events are not regularly held in competition with private business.¹²

In addition, the legislature created a new exemption for sales to nonprofit educational, charitable, and religious institutions although sales by such organizations remain taxable.¹³ Sales to governmental units for use in government functions are also exempt.¹⁴ Furthermore, the 1976 General Assembly saw fit to expand the already long list of exemptions to include receipts from the sale of coal sold for home consumption to Kentucky residents,¹⁵ tombstones and other grave markers,¹⁶ and tickets for admission to "historical sites."¹⁷ Also exempted

¹⁰ KRS § 139.480(4) (Supp. 1976).

¹¹ KRS § 139.531 (Supp. 1976).

¹² KRS § 139.496 (Supp. 1976).

¹³ KRS § 139.495 (Supp. 1976).

¹⁴ KRS § 139.470(7) (Supp. 1976).

¹⁵ KRS § 139.470(8) (Supp. 1976).

¹⁶ KRS § 139.480(11) (Supp. 1976).

¹⁷ KRS § 139.482(2) (Supp. 1976).

are repair and replacement parts for farm machinery.¹⁸

The 1976 Special Session also modified Kentucky's sales tax provisions by clarifying the definition of "machinery used for new and expanded industry."¹⁹ This amendment specifically exempts not only machinery used in manufacturing but also that used in processing. The processing and packaging of raw, in-process, and finished products as well as the processing and packaging of farm and dairy products for sale, and the extraction of minerals, ores, coal, clay, stone, and natural gas are among the processes for which the exemption is applicable. The legislature made this change to bring the statutory definition in line with that already adopted by the Kentucky Revenue Department,²⁰ to clarify for the courts the legislative intent, and to prevent processing companies from being forced to move to other states where processing machinery is not subject to sales tax.

IV. PROPERTY TAX

The homestead exemption was also clarified and liberalized.²¹ No longer must exempt property be occupied as a "single family residence;" occupation as a permanent resident by the owner will suffice.²² Furthermore, the residence will remain qualified even though ownership is by a condominium arrangement or is held indirectly through stock ownership in a corporation owning a leasehold enduring 98 or more years. In the case of joint tenancy it is no longer required that both tenants be 65 or older.²³

In addition to the homestead exemption, another area of property tax law was also changed in 1976. This change, however, was made partially by the Court. In 1969 the Kentucky Constitution was amended to provide that assessing authorities shall value "agricultural and horticultural land according to the land's value for agricultural or horticultural use."²⁴ In Feb-

¹⁸ KRS § 139.480(9) (Supp. 1976).

¹⁹ KRS § 139.170 (1970), amended by Ky. Acts ch. 7 (1976).

²⁰ 103 KY. ADMIN. REGS. 30:120 (1976).

²¹ KRS § 132.810 (Supp. 1976).

²² KRS § 132.010(11),(12) (Supp. 1976) (definition of homestead and residential unit).

²³ Ky. Acts ch. 285, § 4 (1972) repealed by Ky. Acts ch. 315, § 2 (1976).

²⁴ Ky. CONST. § 172A.

ruary 1976, the Supreme Court affirmed the Fayette Circuit Court by holding that valuation based solely on comparable sales of similar land currently used for agriculture failed to comply with the constitutional mandate.²⁵ As a result of this action, the legislature was forced to do away with the now unconstitutional provision that "[a]gricultural or horticultural value means representative sales prices of comparable land purchased for agricultural or horticultural use"²⁶ In its place the General Assembly redefined agricultural and horticultural land to include a sliding scale of income. To qualify for the special valuation a specific annual gross income and income per acre must be exceeded.²⁷ This definition of qualified land denies the special valuation treatment to land not in fact used for farming.

Of special importance to owners of coal and other minerals is the recently enacted legislation on the assessment of real property for state ad valorem taxes. This provision requires that "unmined coal and any interest therein, in whatever form held, including, but not limited to, leasehold and royalty interests shall be taxed at the rate of thirty-one and one half cents (31½¢) per one hundred dollars (\$100) of assessed value."²⁸ Prior to January 1, 1977, the rate was only 1½ cents per \$100 valuation and was under the general provision applicable to all real property.²⁹ Until that time there was no special provision for the separate assessment of mineral interests; they were assessed, if at all, as part of the land. Thus, for the first time, the legislature has manifested an intention to subject Kentucky's extensive coal reserves to property taxation.

Numerous problems, foreseen and unforeseen, will undoubtedly result for the Department and the owners of the coal

²⁵ Kentucky Bd. of Tax Appeals v. Gess, 534 S.W.2d 247 (Ky. 1976). The Court held that the current selling price of similar land cannot be used to value other agricultural land because this might reflect "factors other than its value for purely agricultural and horticultural purposes." *Id.* at 249.

²⁶ Ky. Acrs ch. 249, § 1 (1970).

²⁷ KRS § 132.010(7)(8) (Supp. 1976). Gross income required to qualify under the statute increases with acreage while the income per acre decreases with size.

²⁸ KRS § 132.020(5) (Supp. 1976) (effective January 1, 1977).

²⁹ KRS § 132.020(1) (Supp. 1976) (effective until January 1, 1977). *See generally Property Tax on Unmined Coal Must Be Made Fair or Dropped*, The Courier-Journal & Times (Louisville), Feb. 20, 1977, § D, at 2, col. 1 (editorial).

interests alike. One problem is valuation. Despite the existence of governmental and industrial zone maps and surveys, estimates of the exact location of the underground coal as well as its quantity and quality are largely guesswork. In most cases an accurate appraisal would require extensive core drilling and sampling, as well as the professional services of geologists to be employed by both industry and the state. Currently the Department of Revenue employs only one such geologist.

Even after the location of the deposits has been disclosed, questions relating to the feasibility and cost of extraction remain as issues pertinent to valuation. For example, when coal is to be reached through underground mining, inquiries must be made into the solidity of the overburden and the extent to which roof bolts and other possible support methods will be necessary to provide a safe ceiling.

Further uncertainties stem from the comprehensive statutory language which is designed to embrace ownership of all interests in coal. The statute taxes not only the owner of the land but also the holder of the leasehold interest. Interests in minerals are often divided between the landowner and several different lessees and sublessees who may have operating or overriding royalty interests. Read one way, the statute would permit taxing the coal's value more than once. The landowner, for example, could be taxed on the entire value of the underlying coal without a reduction for the separate interests of his lessee and sublessee who must also pay a tax based on the coal's value. Another possible interpretation, however, is that the total value of the coal is to be divided among the various interests.³⁰

A literal interpretation of the statute would also require that coal underneath residential and subdivision property be assessed. This, however, may be used to the taxpayer's benefit. Because surface property is subject to higher rates due to county, city, and school district taxation and the underlying mineral interest is taxed by the state at only 31 1/2 cents, the owner of valuable property might pay less total property tax if

³⁰ See, e.g., KY. COAL J., Dec. 1976, at 1. This article states that: "Operators will be taxed only for the surface and the mineral they own in fee." *Id.* at 18. This same article describes the tax as ". . . ludicrous. But it's law. And it's a case of fraud if you don't report." *Id.* at 1.

he persuaded assessors to allocate a proportionately higher percentage of the land's total value to the mineral interest rather than the surface interest.

V. INCOME TAX

New legislation, particularly Senate Bill 203, improved Kentucky's income tax law by removing approximately 200,000 Kentuckians from the tax rolls.³¹ This was accomplished by raising the amount of adjusted gross income which could be earned before the filing of a return was required,³² and increasing the tax credit from \$20 to \$60 for individuals who are either blind or over 65.³³ In addition, the standard deduction, which is taken in lieu of itemization, was raised from \$500 to \$650,³⁴ and the tax table for income below \$8,000 was revised.³⁵ Unfortunately, although the minimum income below which a return is not required was raised, the new limit is not the same as the limit provided by federal law.³⁶

Another improvement brought Kentucky's requirements for filing declarations of estimated income tax into conformity with previously enacted federal provisions. The maximum amount of income not subject to Kentucky withholding taxes which can be earned before the taxpayer is required to pay estimated taxes was raised to \$2,000. Even for amounts over \$2,000, declarations are now required only if the estimated tax is \$40 or more.³⁷

Other than the above mentioned changes, the General Assembly did nothing to coordinate Kentucky's income tax with

³¹ See generally LEGISLATIVE RECORD, Apr. 5, 1976, at 9, col. 2-3 (news summary).

³² KRS § 141.180 (Supp. 1976). The new limits are \$1,650 for a single individual, \$2,650 in combined income for married persons living together, \$3,650 for a person who is either over 65 or blind, and \$4,900 for a person who is over 65 and blind.

³³ KRS § 141.020(d), (f) (Supp. 1976).

³⁴ KRS § 141.081(1) (Supp. 1976).

³⁵ KRS § 141.023 (Supp. 1976).

³⁶ See generally INT. REV. CODE OF 1954, §§ 141 (standard deduction), 151 (personal exemptions). It has been suggested previously that Kentucky would profit by conforming its tax laws to the federal laws. See Whiteside & Moss, *Conformity of Kentucky's Personal Income Tax with the Federal Model*, 61 Ky. L.J. 464 (1972); Whiteside, *The Kentucky Law Survey-Kentucky Taxation*, 64 Ky. L.J. 371 (1976).

³⁷ KRS § 141.300 (Supp. 1976).

new federal changes.³⁸ As previously noted,³⁹ Kentucky's income tax law generally follows the federal law's determinations of income and allowable deductions, and then adjusts these figures. A 1976 proposal which would have greatly simplified the whole state income tax procedure, by making the state tax owed a percentage of federal tax paid, failed to pass the General Assembly.⁴⁰

VI. PROCEDURAL MATTERS

Although Kentucky's revenue bills contain many substantive changes, there were also procedural changes: one such change involves the interest rate charged on delinquent taxes. This was raised from 6 to 8 percent,⁴¹ for taxes other than property tax. The penalty on state, county, and city property taxes which are unpaid on January 1 was increased from 6 to 10 percent,⁴² and a new penalty was provided for the failure to pay income taxes.⁴³ In another change, the time within which a refund from the Department of Revenue can be claimed was extended from 2 to 4 years.⁴⁴

VII. UNIFORM GIFT TO MINORS ACT

In another legislative development, the General Assembly attempted to bring the Kentucky Uniform Gift to Minors Act⁴⁵ [hereinafter cited as the Act] into conformity with the state's general definition of minority,⁴⁶ an attempt which only complicated the statute. Although not directly a tax issue, the Act will interest the tax practitioner who often uses this method of tax

³⁸ For suggestions of needed coordination, see Whiteside & Moss, *Conformity of Kentucky's Personal Income Tax with the Federal Model*, 61 Ky. L.J. 464 (1972).

³⁹ Whiteside, *The Kentucky Law Survey-Kentucky Taxation*, 64 Ky. L.J. 371 (1976).

⁴⁰ H.B. 380, 1976 Ky. Gen'l Assembly. This proposal was introduced by Rep. Louis DeFalaise of Covington.

⁴¹ KRS § 136.990 (Supp. 1976) (Corporation license tax); KRS §§ 139.650, 139.740(5), 139.980(4) (Supp. 1976) (Sales and Use tax); KRS § 140.210(1) (Supp. 1976) (Inheritance tax); KRS § 141.990 (Supp. 1976) (Income tax). See also KRS § 134.580 (Supp. 1976) (Interest paid on refunds).

⁴² KRS § 134.020(2),(3) (Supp. 1976).

⁴³ KRS § 141.990 (Supp. 1976).

⁴⁴ KRS § 134.580(3) (Supp. 1976).

⁴⁵ KRS § 385.011 *et. seq.* (1970), as amended (Supp. 1976).

⁴⁶ KRS § 2.015 (1970).

planning in an effort to minimize state inheritance and federal estate taxes.

For purposes of the Act, the 1976 legislation redefines minor as "a person who has not attained the age of eighteen (18) years."⁴⁷ Although the new definitional provision changed the age of a "minor" to a person under 18, the legislation failed to change KRS § 385.041 which continues to provide that the property is to be delivered "to the minor on his attaining the age of twenty-one (21) years" Did the legislature intend to withhold delivery until the donee reaches 21⁴⁸ even though the gifts can be given only to minors, those under 18, or should "minor" be read to supersede "21" and allow delivery at the age of 18? The answer is at best ambiguous.

Although the General Assembly's oversight could be corrected by providing that the property be turned over to the minor donee at the age of 18, a more sound policy would result from a repeal of the abortive attempt to lower the age for purposes of the Act.⁴⁹ Many people relied on age 21 when gifts were created and should not now be forced to deliver the property when the donee reaches 18; the donor may feel that the donee is not sufficiently mature to manage the property at age 18. As to past gifts, requiring the property to be transferred at age 18 renders the donor's careful planning ineffective. For future gifts, donors may be forced to resort to more complicated instruments, such as a regular trust. The Act must be clarified by the legislature and hopefully it will undo the harm by repealing the new definition of "minor." If not, it should at least minimize the harm by providing that the new definition does not affect gifts completed before the change takes effect. This would allow the custodian to retain control until the donee reaches 21 if the property was given before the amendment's enactment.

⁴⁷ KRS § 385.011(13) (Supp. 1976).

⁴⁸ Age 21 agrees with the definition of "minor" in the act promulgated by the Commissioners on Uniform State Laws and with the original definition provided by the Kentucky legislature. *See* KY. ACTS ch. 202, § 1 (1966).

⁴⁹ *See also* OP. KY. ATT'Y GEN. 72-317. In this opinion the Attorney General stated that in the interest of uniformity the age of majority for the Gifts to Minors Act should remain 21, despite the legislative change of the age of majority for most purposes to 18. KRS § 2.015(1970). This opinion, however, was issued prior to the legislature's 1976 action.

