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Some Recent Kentucky Tax Cases
Of Economic Significance

By James W. Martin*

Numerous tax decisions by the Kentucky Court of Appeals since midcentury have comparatively little meaning beyond the scope of the issues immediately concerned in the litigation. A few cases have significance far beyond the scope of the subject matter directly in controversy. This brief paper is designed to analyze some economic implications which follow from the three recent decisions that appear to embody legal changes affecting economic relationships. The three cases are otherwise unrelated.

Of the three cases, one appears to constitute an impediment to economic growth. Both the others have the long-range effect of removing earlier judicially-imposed interference with the progress of the economy. The arrangement of the paper is based on this classification of the cases, the economically constructive ones being given the place of major emphasis at the end of the paper.

I

The Kentucky income tax statute prior to 1954 provided in general for deduction of federal income tax in computing the income for state taxation. It also reflected an over-all effort to define a uniform income base for the computation of each taxpayer’s liability. There is even included a provision relating to the Kentucky taxpayer’s accounting practice to the effect that, “if the method employed does not clearly reflect the true income of the taxpayer, the computation shall be made upon the basis and in the manner that in the opinion of the Department of Revenue clearly reflects the true income.” The same legislative purpose is

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1 Ky. Rev. Stat. secs. 141.010 et seq. The Department of Revenue has also reprinted the text in Income Tax Law and Regulations.

again reflected in a provision of Kentucky Revised Statutes section 141.120 reading as follows:

In the event the formula for allocating income prescribed herein, as applied in a particular case, reaches an unconstitutional result, or the department determines that said formula as applied in a particular case fails to allocate to Kentucky a fair and reasonable portion of business income, the department shall prescribe a formula which allocates to Kentucky a fair and reasonable portion of the business income.  

In the case of Clayton and Lambert Manufacturing Co. Inc. v. Kentucky State Tax Commission et al., the Kentucky Court of Appeals was confronted with a specific problem involving the construction of these provisions. The facts may be summarized briefly. The manufacturing company, a Delaware corporation, maintained its principal place of business in Louisville; but in 1946 it sold a valuable property in Michigan on which it made a substantial capital gain. The case before the court sought to determine whether the federal tax paid on the capital gain was or was not deductible in computing the base of the Kentucky income tax. The court held that that tax constituted a deductible item.

The practical economic result of this ruling is to render the discriminatory effect of the deduction of federal income tax (in conjunction with the apparently inevitable differences between federal and state coverage) even more pronounced than it would be without this construction. Let us assume that the taxpayer's capital gain is $256,000 on which the federal tax is $64,000. Suppose the income from operations, all in Kentucky, amounted to $75,000 after all deductions except the federal capital gains tax. Under these conditions, the corporate income taxable in Kentucky would be $11,000, which at 4 per cent would mean a tax payment of $440. A competitor, conducting the same kind of business and enjoying identical Kentucky income, would in the absence of any irrelevant Michigan transaction be required to pay

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*In a relationship only generally relevant to the present discussion.

Ky. Rev. Stat. sec. 141.120(2).

265 S.W. 2d 449.

*That the inadvertent discriminations without this one are substantial and varied has been demonstrated elsewhere. Lockyer and Martin, *Some Kentucky Income Tax Discriminations*, 39 Ky. L.J. 377 (1951).*
This competitor must pay nearly seven times as much income tax on the identical amount of income derived from the same sort of Kentucky source. Is this discrimination just? Is such an application of the statute, as construed, even consistent with the Kentucky constitution?

If the discriminatory effect of the decision—probably operative as to fairly numerous taxpayers—is apparent, it remains only to add as to this case that the General Assembly hastened to revise the earlier language of the statute.  

II  

In Reeves v. Island Creek Fuel and Transportation Co., the Kentucky Court of Appeals held liable for ad valorem property tax a Maine corporation, having its principal place of business in West Virginia and engaging in contract transportation for its parent on the Ohio River between Huntington, West Virginia, and Cincinnati, Ohio. The Corporation operated mooring facilities in Campbell County, Kentucky. The court ruled that the property of the transportation company was subject to Kentucky's taxing jurisdiction and was properly apportioned to the state on the basis of a mileage prorate. The doctrine of the Island Creek case appears to eventuate inevitably from the concept of jurisdiction developed in Ott v. Mississippi Valley Barge Line Co.

The practical results of the earlier view of the courts, which in Kentucky had been extended beyond the bounds established by the United States Supreme Court or, as far as the writer has discovered, by the supreme court of any state other than Kentucky, has been largely, in effect, to exempt the vessels of transportation

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Footnotes:

3 This last query is of only incidental significance for the purposes of this paper. It is raised because of the legal concept of statutory construction which makes it the court's duty to construe an ambiguous statute, if possible, in such a manner that the statute will be constitutional.

6 KY. REV. STAT. sec. 141.010 (8). There is a typographical error in the citation in Alphin, 1954 Kentucky Tax Legislation, 43 KY. L.J. 76 at 80 (1954).

9 313 Ky. 400, 230 S.W. 2d 924 (1950).


12 In Reeves, Com'r et al. v. Service Lines, Inc. 291 Ky. 410, 164 S.W. 2d 593 (1942).
companies from ad valorem taxation. This result was accomplished by the rule that only the state of domicile could tax vessels used interstate and by the resulting practice of chartering water transportation corporations only—or almost so—in the few states which did not have a tax on such property. However, this freedom from property taxation did not apply in the same degree to ferries and sometimes to other localized water transportation holdings.\(^3\)

The Island Creek case\(^4\) effects a substantial change in the distribution of the incidence of state and local carrier taxes. On such businesses in the aggregate, the ad valorem property tax constitutes a heavy proportion of the total state and local tax load. Prior to 1950, it is practically correct to say that ferries and land, air, and rail transportation properties paid the property tax bill, and owners of vessels engaged in other water transportation paid none. The net effect of 1950 decision will be largely to distribute the ad valorem tax load according to the relative values of the properties employed in carrier businesses.

The absolute amount of tax payments involved in the litigation, either directly or as a result of action subsequently taken in compliance with the court's decision, is not great. The volume of river transportation in Kentucky waters is not sufficient to require the use of heavy investment in barges and other vessels. Thus, the economic consequences in terms of the amount of public revenues are less significant than in terms of the distribution of the transportation tax load.

III

In Citizens Fidelity Bank and Trust Co. v. Reeves,\(^5\) the Kentucky Court of Appeals took a major step toward making possible refined property appraisals for tax purposes. In so doing, the court overruled a series of Kentucky cases\(^6\) which had resulted in somewhat of a strait jacket for valuation officials.

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\(^3\) Perhaps the best study of the legal and economic aspects of these issues is found in the authoritative United States Board of Investigation and Research (Transportation Act of 1940), CARRERA TAXATION 259-312, 349-895.

\(^4\) It appears that another Kentucky case is now pending to ascertain whether, under the doctrine, newly applied to water transportation, vessels conducting business in the same Kentucky stream but not maintaining any physical contact with the shore of Kentucky are subject to the state's taxing jurisdiction. The result of this litigation may conceivably modify the textual statement of the economic consequences of the Island Creek case.

\(^5\) 259 S.W. 2d 432 (1953).

\(^6\) Notably Bingham's Adm'r et al. v. Commonwealth, Commonwealth v. Bing-
The basic Kentucky problem in modern tax valuations has stemmed from the Court of Appeals decision in the Bingham case. There the problem was similar to that submitted in the Citizens Fidelity case. Mrs. Bingham's estate included, among other properties, 16,400 shares of Standard Oil of New Jersey common stock. The personal representative introduced evidence that the sale of such a large block of stock would have depressed the market so that the fair market value per share of the property to be appraised would not have been the same as, but considerably less than, the market quotations on the sale of the few hundred shares actually involved in the transactions near the date of Mrs. Bingham's death. Although seeming to admit the appraisal facts urged by the administrator, the court held as a matter of law that the property must be valued for taxation at the figure fixed by sales of small lots of the stock on or about the date as of which the property was to be appraised.

To an appraiser, the Bingham case introduced three sorts of impediments to accurate valuation even though obviously in most instances no error results from the direct employment of market quotations. In the first place, the case, more because of the opinion than of the decision, appeared to require a rigidity of conception not consistent with the economics of appraisal. In this view, the court was in a measure supported by earlier rulings. Competent appraisers know that, if a property is sold, there is no assurance that the price fixed by the sale would be the same as that which would be fixed by another sale the same day. That is, the fair market value of a property to an appraiser is not a metaphysical entity or a rigidly fixed amount. Rather, it is the value which is most likely to be arrived at in a free market in which buyers and sellers have the degree of information about the property that parties to a transaction normally have. To the appraiser, the

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7 Bingham's Adm'r et al. v. Commonwealth, Commonwealth v. Bingham's Adm'r et al., 244 S.W. 781 at 789 and 790 (1922).

8 Especially Eminence Distillery Co. v. Henry County Board of Sup'r et al., 178 Ky. 811, 200 S.W. 347 (1918), which the court cited with approval.

9 It is a commonplace that, aside from the fact that one party to a sale may be a better bargainer than the other, there are variations in sale prices in a particular market because different equally well informed buyers and sellers place varying estimates on the probable productivity of a particular property.
market value is a sort of average\textsuperscript{20} of prices fixed in imaginary sales; or it is a range within which a free market transaction will probably fall. This true-to-life conception is all but ruled out by the Bingham case.

Secondly, the case precludes the consideration of the economically relevant evidence that blockage may result in a sale price for a large amount of securities lower than the prevailing market prices. This is exactly the problem involved in the Bingham and the Citizens Fidelity cases and requires no further comment.

In the third place, the Bingham case rules out the possibility that the element of control, the right to select officers and employees and to fix their compensation and to determine dividend policy, might involve an important cause of variation of fair market value of corporate stock \textit{upward} from quotations of current sales of minority shares. To a degree this issue was involved in the Frankfort State National Bank case. At any rate, it is well known in business circles that the right to control a small corporation is often extraordinarily valuable. For instance, a small, local corporation may over a period of 10 or 20 years pay a dividend equal to 20 or 30 per cent of the annual income available for dividends. Meantime, the majority stockholder is accumulating the remaining 70 or 80 per cent of the income for future distribution—or possibly with no intent to distribute—under such conditions the value of the majority share-owner's holdings is not even remotely approximated by the sale price paid for a minority of the shares. Again, the person who controls a corporation may well pay to himself and to members of his family officers' salaries totally out of line with the service rendered, thereby depressing income and hence lowering the selling price of minority shares. In both these sorts of cases, the tax administrator certainly should have a right to estimate fair cash value at a figure well above the current selling price of occasional small blocks of shares. Under the Bingham case doctrine, administrators were compelled to ignore such considerations as to fair market value and fix tax assessments on the basis of occasional sales.\textsuperscript{21}

\textsuperscript{20} More likely to be a mode than a mean, but not invariably a modal figure.

\textsuperscript{21} As a Kentucky tax administrator, the writer has confronted all these kinds of embarrassment.
There is a legal hiatus which has been occasioned by the Bingo-
ham case and which involved a special case of the second or third
difficulty just outlined. There is common sense persuasiveness
based on established legal grounds\(^\text{22}\) to the effect that the price at
which a personal representative can liquidate securities under cer-
tain conditions constitutes persuasive corroborative evidence of
fair market value for tax purposes. Essentially, the conditions are
(a) that, subsequent to the date as of which the valuation is made,
there is evidence that little or no change has occurred in market
conditions and (b) that the personal representative worked con-
tinuously toward a sale from substantially the date of the de-
cedent's death until the transaction is consummated but without
such haste as might involve compulsion.\(^\text{23}\) In the estate of A, the
Kentucky Department of Revenue\(^\text{24}\) found that the decedent
owned a large amount of stock, constituting a heavy proportion
of the total, in a corporation which he had long served as president.
Scattered sales immediately prior to death established the value
according to the Bingham case fiat. But counsel for the estate
undertook to prove a blockage differential and insisted that the
personal representative had liquidated the stock as promptly as
cautiousness permitted and that he had been compelled to accept
considerably less than the prices established by the earlier trans-
actions. Meantime, there had been no considerable change in
prices in sales of minority holdings. Thus, in this case, as well as
in other cases, the Bingham case rule in the rigid form laid down
in the opinion squarely contradicted facts which other courts, as
well as professional appraisers, regard as relevant evidence of
value.\(^\text{25}\)

In the Citizens Fidelity case, handed down in 1953 as already
noted, the court, of course, could decide only the issues before it.

\(^{22}\) Commissioner of Internal Revenue v. Stewart's Estate, 153 Fed. 2d 17 and
cases there cited. Note also the cases cited in the Citizens Fidelity case, loc. cit.
supra note 14.

\(^{23}\) Although the language of the text is related to death taxation, the same
kind of evidence is relevant and the same conditions are applicable in other tax
valuations. Cf. Martin and Estill, Valuation of Property: Economic and Legal
Standards, 38 Ky. L.J. 7 (1949).

\(^{24}\) At the time, the present writer was Commissioner of Revenue.

\(^{25}\) Although the actual sale in the case of A's estate occurred subsequent to
the date as of which the valuation was required, there was plenty of expert
testimony as of the date of death to forecast the result which was subsequently
obtained. Technically, the subsequent transaction is merely in the nature of con-
firming evidence.
In the opinion, however, Judge Combs went on to explain the unanimous court's position as follows:

> It will be seen from the foregoing resumé that the so-called "unit" rule adopted in the Bingham case is not in harmony with the weight of authority and especially with the later cases. Counsel for the Commission admit this and also admit that in many cases complete reliance upon the "unit" rule might result in prejudice to the state as well as the taxpayer. If the taxpayer is prohibited from introducing evidence to show that the stock exchange price of one share of stock on a given day does not represent the "unit" value of a block of similar stock in the hands of the taxpayer, so is the commission. Obviously the rule must work both ways. . . .

Thus, it appears that the practical outcome of the recent litigation is to place the Kentucky Court of Appeals in the camp of those persons, including perhaps all professional appraisers, who insist that an administrative body does not err when it finds fair market value "by weighing all relevant indicia of what the stocks would bring at market." This outcome will certainly eliminate a great deal of discrimination from a relatively small number of cases if the court follows the pronouncement unanimously laid down:

> Both the taxpayer and the Commission should have the right to introduce extraneous evidence for the purpose of showing that the price for which stock is sold on a stock exchange on a given date does not necessarily represent the unit value of similar stock held by a taxpayer on that date. We do not undertake to say how much weight the Commission should give to such evidence if it is introduced. Undoubtedly the stock exchange price would be the best evidence of value in most cases. That would be prima facie the value of the stock. But the Tax Commission, whose duty it is to determine the actual fair cash value of the stock in the manner prescribed by the Constitution, should be permitted to hear competent evidence which might rebut the presumption created by the stock exchange.

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20 Concluding phrase in Commissioner of Internal Revenue v. Stewart's Estate, 153 Fed. 2d 17. This point is fully developed in the light of the self-executing section 172 of the Kentucky Constitution in Martin and Estill, loc. cit. supra note 23.