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Kentucky Law Survey: Kentucky Taxation

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Kentucky Taxation

BY FREDERICK W. WHITESIDE* and JOHN R. HARMAN**

The most significant changes in the Kentucky tax law last year involved inheritance, sales, and income taxes. As can be expected in a legislative year, the impact of new legislation overshadowed the developments resulting from judicial decisions. The primary changes were in income, inheritance, sales and use, and coal severance taxation.

I. INCOME TAX LEGISLATION

The General Assembly long ago adopted a policy of using the federal income tax system "as nearly as practicable"[1] as a guide for the calculation of income and deductions for the Kentucky individual income tax. Despite this announced policy, many differences have arisen over the years. The need for much closer conformity of the state law with the federal has been urged in previous articles on the grounds that it would reduce the difficulty and expense of compliance by individual taxpayers and increase its efficiency.[2] However, keeping Kentucky income tax law abreast of the everchanging federal Internal Revenue Code requires updating the Kentucky statutes at each legislative session to incorporate the increasing volume of federal code amendments enacted since the previous General Assembly. These efforts are plagued with problems of obtaining support for revisions of the Kentucky statutes and a constant time lag.

A. *Dependent Care Deduction*

An example of the problem of catching up with the federal

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[1] KY. REV. STAT. § 141.050(11) (1970) [hereinafter cited as KRS].

[2] Whiteside and Moss, *Amending Kentucky's Individual Income Tax Law*, 38 KY. B. J. 48 (1974); Whiteside and Moss, *Federal—State Income Tax Relationships—Conformity of Kentucky's Personal Income Tax With the Federal Model*, 61 KY. L.J. 462 (1973).

changes arose in 1978, along with additional problems of variation from the federal model, in connection with the income tax benefit allowed working persons for the care of dependents. Kentucky Revised Statutes § 141.010(11) authorizes the taxpayer to deduct from adjusted gross income all deductions "allowed individuals by Chapter 1 of the Internal Revenue Code."[3] However, the Tax Reform Act of 1976 repealed the dependent care deduction[4] and substituted an income tax credit.[5] This repeal of the federal deduction left Kentucky without any tax benefit for the care of children of working taxpayers. Instead of following the recent federal shift from deductions to credits, the 1978 General Assembly re-enacted the old federal deduction from gross income allowed "by Section 214 of the Internal Revenue Code as it existed on December 31, 1975."[6]

The requirements to qualify for the full deduction are:

(1) Only those dependent care expenses which "are incurred to enable the taxpayer to be gainfully employed"[7] are deductible.
(2) The household must contain a dependent or spouse who is incapable of caring for himself or a child under fifteen who either is a student or earns less than $750 per year.[8]
(3) The taxpayer and his spouse must furnish more than one-half the cost of maintaining the household.[9]
(4) If the taxpayer and his wife jointly earn over $35,000 per year, the deduction will be reduced by one-half the income exceeding $35,000 per year. The reduction, however, is calculated on a monthly basis so that the reduction for each month depends upon the excess over an annual income of $35,000

[3] KRS § 141.010(11) (1970) (amended 1978).

[4] I.R.C. § 214 (repealed by Tax Reform Act of 1976, Pub. L. No. 91-190, § 504 (b)(i), 90 Stat. 1565).

[5] Act of Oct. 4, 1976, Pub. L. No. 94-455, § 504(b)(i), 90 Stat. 1565 (repealing I.R.C. § 214).

[6] KRS § 104.010(11) (Supp. 1978).

[7] I.R.C. § 214(b)(2) (repealed 1976).

[8] *Compare* I.R.C. § 214(b)(2) (repealed 1976), which provided for the deduction of some costs of caring for dependents and spouses who are incapable of caring for themselves and which provided for deduction of some costs of caring for children under nineteen who are qualified under I.R.C. § 151(e), *with* I.R.C. § 151(e), which provides that children who earn less than $750.00 per year or who are students are qualified.

[9] I.R.C. § 214(b)(3) (repealed 1976).

which is attributable to that month.[10]
(5) If the dependent care expenses are for services rendered outside the home, the deduction is limited to $200 per month for one dependent and $300 per month for two dependents and $400 per month for three or more dependents.[11]

B. *Casualty Loss Deduction*

Until 1978, casualty and disaster losses were deductible only under KRS § 141.010 (11), which authorizes the taxpayer to deduct all items that are deductible on the federal return.[12] In 1978 the General Assembly enacted KRS § 141.011, a separate provision allowing the deduction of casualty and disaster losses. As under the prior law, casualty losses will normally be deductible only in the year they are incurred,[13] except that the loss can be deducted in the year preceding the occurrence if the President of the United States determines that the disaster warrants assistance under the Disaster Relief Act.[14] KRS § 141.011 modifies the previous provision by empowering the taxpayer to carry forward all casualty losses which are in excess of the current year's income regardless of Presidential Declaration. It also authorizes the taxpayer to carry over deductions to succeeding years whenever the casualty or disaster losses exceed income in the year they are first deductible.[15] Thus the ability to obtain some tax benefit to offset a casualty loss will no longer depend on the fortuitous circumstances of whether the taxpayer has sufficient income in the year of the loss.

II. INHERITANCE TAX

The most important action of the General Assembly affecting inheritance taxes is the relief provided by a substantial

[10] I.R.C. § 214(d) (repealed 1976).

[11] I.R.C. § 214(c)(2) (repealed 1976).

[12] KRS § 141.010(11) (1970) (amended 1978) allows deduction on the state income tax return of those deductions allowed on the federal return by chapter 1 of the Internal Revenue Code which have not been specifically excluded by a state provision. I.R.C. § 165, which authorizes taxpayer deductions of casualty and disaster losses, is such a deducton.

[13] The prior law was I.R.C. § 165(c)(3), adopted pursuant to KRS § 141.010(11) (1970).

[14] KRS § 141.011 (Supp. 1978).

[15] *Id.*

increase in the exemption allowed a surviving spouse, minor child, or incompetent adult. The exemption for property passing to a surviving spouse of a decedent dying after July 1, 1978, is $50,000 (in lieu of the former $20,000) and the exemption for property passing to a minor child or incompetent adult child is raised from $10,000 to $20,000.[16] The rates and the tax brackets for each rate remain unchanged. The seemingly generous increase in the exemption amounts, however, is somewhat illusory. It will not yield a commensurate decrease in inheritance taxes for larger estates because the exemption is first applied to property which would have fallen in the lower rate brackets.[17] For example, if $150,000 passes to a surviving spouse, the $50,000 exemption will be applied against property which falls within the two to five percent rates, while the remaining $100,000 will be subjected to the five percent rates.

A. *Special Valuation of Agricultural Property*

A new provision, effective July 1, 1978, permits valuation of certain property at its agricultural or horticultural value rather than the fair market value of the property in its best use.[18] This provision is similar to section 2032A of the Internal Revenue Code in that it gives preferential tax treatment to agricultural property descending to a family member who continues to operate the farm for five years after the decedent's death.[19]

To qualify for special valuation the "fair cash value" of the property must exceed fifty percent of the decedent's gross taxable estate[20] and the property must have been operated as a farm for five continuous years prior to the owner's death.[21] The prop-

[16] KRS § 140.080(1) (Supp. 1978).

[17] The new statutory language provides that the exemptions shall be "chargeable against the *lowest* bracket or brackets of inheritable interests," KRS § 140.080(1) (Supp. 1978) (emphasis added). Thus the *tax* is applied to the higher progressive rates. This change from previous law was intended by the 1978 General Assembly when it enacted Chapter 38 of Kentucky Acts, 1978. *See also* Instructions to the Inheritance and Estate Tax (Form 92A120(1), 7-78), p. 8, as applied to decedents dying after July 1, 1978.

[18] KRS § 140.310 (Supp. 1978).

[19] KRS § 140.300 (Supp. 1978).

[20] KRS § 140.300(4)(c) (Supp. 1978).

[21] KRS § 140.300(4)(b) (Supp. 1978).

erty must be used for agricultural or horticultural purposes and must either have produced a statutorily specified minimum income during three of the five years prior to death or there must be evidence that it will produce that minimum income in the future.[22] Finally the farm must descend to a spouse, child, or child's spouse[23] and the tract must be at least five to ten acres depending on what it produces.[24]

The property's fair market value as well as its agricultural value must be reported when the inheritance tax return is filed.[25] In no case can the special valuation reduce the gross estate by more than $500,000.[26] The following chart demonstrates the effect of the new provision on the gross taxable estate.

	Estate X	Estate Y
FMV of Gross estate	2,000,000	2,000,000
Fair Cash Value of Farm	998,000	1,002,000
Fair Cash Value of Farm as a percentage of gross estate	49.9%	50.1%
Agricultural Value of Farm	500,000	500,000
Fair Cash Value less agricultural value	498,000	502,000
Reduction in Gross Taxable estate due to special valuation	0*	500,000**

* Estate X did not qualify because the fair cash value of the farm did not exceed 50% of the gross taxable estate.

** The reduction in the gross taxable estate is less than the difference between FMV and agricultural value of the farm in estate Y because the special valuation cannot be used to reduce the gross estate by more than $500,000.

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[22] To qualify, the property must be agricultural or horticultural land. KRS § 140.300(4)(a) (Supp. 1978). Horticultural land is:

> any tract of land, including all income producing improvements but excluding all residences, of at least five (5) contiguous acres in area commercially used for the cultivation of a garden, orchard, or the raising of fruits or nuts, vegetables, flowers or ornamental plants, where such activities produced an average annual gross income

which varies with the size of the farm. KRS § 132.010(8) (Supp. 1978). Agricultural land is defined as a ten-acre or larger tract "used for the production of livestock, livestock products, poultry, poultry products and/or the growing of tobacco and/or other crops including timber" or where qualifying under federal or state agricultural programs and provided the property produces a minimum average income which varies with the size of the farm. KRS § 132.010(7) (Supp. 1978).

[23] KRS § 140.300(5) (Supp. 1978).

[24] KRS § 132.010(7)-(8) (Supp. 1978). It requires that horticultural property be at least five acres and that agricultural property be at least ten acres.

[25] KRS § 140.340 (Supp. 1978).

[26] KRS § 140.360 (Supp. 1978).

Where qualified real estate has been assessed at its farm value for the *ad valorem* tax, that valuation will be presumed valid for the inheritance tax. Otherwise, the assessment procedure outlined in KRS § 132.450 for the *ad valorem* valuation will be used.[27]

If within five years of the owner's death the farm is transferred to other than a qualified family member or is converted to a non-farming use, the qualified person who took the property at death must pay the additional tax that would have been due on the estate if the farm had been assessed at its fair market value in its best use.[28] In the event that the person to whom the estate passed does not pay, the new act provides for a lien against the farm out of which the additional taxes can be collected.[29]

The Kentucky provision allowing special valuation is simpler and in several ways much more restrictive than section 2032A of the Internal Revenue Code. There are four major differences between the two provisions. First, although both provisions allow special valuation of property which makes up fifty percent or more of the gross estate,[30] the federal provision allows for special valuation of property if it constitutes at least twenty-five percent of the gross estate and if the decedent or a member of his family materially participated in the operation of the property.[31] Second, the federal provision permits special valuation of any property used in a trade or business at its value in that business,[32] while the Kentucky provision applies only to agricultural or horticultural property.[33] Third, KRS § 140.300 allows special valuation only if the property passes to a spouse, child, or a spouse of a child. Under the federal provision the qualified heirs may come from a larger group consisting of an "individual's ancestor or lineal descendent, a lineal

[27] KRS § 140.330 (Supp. 1978).

[28] KRS § 140.320 (Supp. 1978). The unpaid tax is also subject to an interest charge of eight percent per year.

[29] KRS § 140.350 (Supp. 1978).

[30] I.R.C. § 2032A(b)(1)(A); KRS § 140.300(3)(c) (Supp. 1978).

[31] I.R.C. § 2032A(b)(1) (B)-(C) provides that a family member must have materially participated in farm operations during five of the eight years preceding the owner's death.

[32] I.R.C. § 2032A(b)(2).

[33] KRS § 140.310 (Supp. 1978).

descendent of a grandparent of such individual, the spouse of such individual, or the spouse of any such individual, or the spouse of any such descendant."[34] Finally, I.R.C. § 2032A(c) provides for penalties if the property's use is changed or if it is sold to a non-qualified heir within fifteen years after death. The more liberal Kentucky provision restricts the sale and use of the property for only five years.[35]

B. *Deferral Provisions*

The 1978 General Assembly added two new inheritance tax deferral provisions. The first allows certain class A beneficiaries[36] receiving a farm or other closely held business to pay the tax in five annual installments. To qualify, the beneficiary's inheritance tax burden must exceed $5,000, and the farm or closely held business must account for at least seventy-five percent of his distributive share.[37] While payments are outstanding the farm or closely held business will be subject to a lien.[38] Upon sale of the farm or business the deferred installments will immediately become payable.[39] The General Assembly also adopted a ten-year deferral provision.[40] The ten-year deferral is available to any beneficiary whose inheritance tax burden is greater than $5,000[41] regardless of the type of property he receives. Under the ten-year provision, none of the property received by the beneficiary is subject to a lien[42] and the beneficiary can relieve himself of the burden of paying interest by paying the installments early. Because the ten-year provision is much more lenient, the five year provision is relatively useless. Under either provision the beneficiary must file

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[34] I.R.C. § 2032A(e).

[35] KRS § 140.300(5) (Supp. 1978).

[36] Class A beneficiaries include the transferor's "parent, surviving spouse, child by blood, stepchild, child adopted during infancy or a grandchild who is the issue of a child by blood, of a stepchild or a child adopted during infancy." KRS § 140.070 (1970).

[37] KRS § 140.151 (Supp. 1978).

[38] KRS § 140.151(6) (Supp. 1978).

[39] KRS § 140.151(1)(c) (Supp. 1978).

[40] KRS § 140.222 (Supp. 1978).

[41] KRS § 140.222(1) (Supp. 1978).

[42] While a beneficiary electing to defer his tax under KRS § 140.222 is personally liable for the tax, there is no provision for creating a lien. KRS § 140.222(4) (Supp. 1978).

an election in writing[43] and pay the first installment when the return is filed.[44] The interest rate under both provisions is eight percent of the unpaid balance.[45] Deferral under either provision releases the personal representative, trustee, or estate from liability on the deferred payments.[46]

C. *Large Estates*

KRS § 140.065, which exempted estates of over $3 million from the inheritance tax, was repealed by the 1978 General Assembly.[47] Henceforth all estates will be subject to both the estate tax and the inheritance tax. Because the Kentucky estate tax is equal to the difference between the state inheritance tax and the maximum state death tax credit allowable against federal estate taxes under I.R.C. § 2011,[48] the Kentucky estate tax never imposed any additional burden. Any state estate tax payable would be offset by a like credit against federal estate taxes.[49] In some instances the federal tax credit which determines the amount of the estate tax is less than the Kentucky inheritance tax. Since the prior law exempted large estates from inheritance tax, net taxes paid by estates over $3 million could be less than the taxes paid by those under $3 million, as illustrated by the following examples:

	Prior Law	Present Law	Prior Law	Present Law
Taxable Estate	2,999,000	2,999,000	3,000,000	3,000,000
Inheritance Tax assuming everything goes to class C beneficiaries*	466,910	466,910	0	466,910
Estate Tax	0	0	230,280	0

* computed under KRS § 140.070 with $500 exemption under KRS § 140.080(5)(e).

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[43] KRS § 140.222(3) (Supp. 1978); KRS § 140.151(5) (Supp. 1978).

[44] KRS § 140.222(1) (Supp. 1978); KRS § 140.151(1) (Supp. 1978).

[45] KRS § 140.222(2) (Supp. 1978); KRS § 140.151(4) (Supp. 1978).

[46] KRS § 140.222(3) (Supp. 1978); KRS § 140.151(5) (Supp. 1978).

[47] 1978 KY. ACTS ch. 233, § 6.

[48] KRS § 140.130(1) (1970). "In addition to the inheritance tax. . ., an estate tax is . . ., levied on all estates equal to the amount by which the credits for state death taxes allowable under the federal tax law exceeds the tax levied under KRS 140.010, less the discount allowed under KRS 140.210, if taken by the taxpayer."

Apparently the federal credit was adopted to reduce the discrepancy between the various states' death taxes. I.R.C. § 2011 reduces a state's ability to advertize itself as a tax haven and thus eliminates one factor which may cause the elderly to relocate.

[49] I.R.C. § 2011 provides that within certain specified limits "[t]he tax imposed by section 2001 [the federal estate tax] shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State."

As the above table illustrates, it would sometimes be to an estate's advantage under the pre-1978 law to inflate valuations or deflate deductions.

D. *Certificates of Deposit*

A decedent's fractional interest in a certificate of deposit held jointly with a right of survivorship is taxed under KRS § 140.050.[50] Until 1978, a surviving joint owner's interest in the certificate was also subject to estate and inheritance taxes if it was received as a gift from a decedent within three years of the decedent's death. All such transfers are presumed to be made in contemplation of death[51] and thus are taxable.[52] During 1978, the General Assembly enacted KRS § 140.020(3) eliminating the contemplation of death presumption for jointly held certificates of deposits,[53] thereby eliminating the tax on a large number of lifetime transfers. This curious new provision changes the law only with respect to the portion of the certificate of deposit the decedent contributed in excess of his fractional interest and for which he received no consideration.

This revision is reasonable in light of the delays and burdens the old provision placed on the banks. Banks are prohibited from paying certificates of deposit without either "retaining a sufficient portion thereof to pay any (inheritance) tax"[54] or obtaining a waiver from the Department of Revenue.[55]

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[50] KRS § 140.050 provides that when any property is held jointly with right of survivorship the decedent's fractional interest in the property is taxed as if it had been owned by the decedent at death and bequeathed to the surviving joint owner.

[51] KRS § 140.020(1) (1970).

[52] KRS § 140.020(2) (1970). This provision is best understood in light of the developing differences between the federal "uniform transfer tax" system and the Kentucky inheritance tax. Because Kentucky has no gift tax, intervivos gifts will act to reduce the size of the estate inherited or bequeathed and thus reduce the inheritance taxes paid. To eliminate the use of gifts as a tax avoidance scheme, Kentucky adopted KRS § 140.020, which is similar to the pre-1977 federal law. Although the Kentucky provision has basically remained the same, the federal provision was changed to eliminate the contemplation of death provision for transfers made after January 1, 1977. Act of Oct. 4, 1976, Pub. L. No. 94-455, § 200(a)(5), 90 Stat. 1848 (amending I.R.C. § 2035). The new federal provision brings back into the gross estate *all* transfers made within three years of death. I.R.C. § 2035.

[53] KRS § 140.020(3) (Supp. 1978).

[54] KRS § 140.250(3) (Supp. 1978).

[55] *Id.*; *see* OP. KY. ATT'Y GEN. 76-501 (1976) for authority that KRS § 140.250(3) is unchanged by KRS §§ 391.315(1), .355 (Supp. 1978). KRS § 391.315(1) provides that

By removing the presumption that the decedent's excess contribution to those jointly-held certificates of deposit was in contemplation of death, the legislature has shifted the burden of proof to the Department of Revenue. Because the likelihood that inheritance taxes will be payable on more than the decedent's interest has been greatly reduced, the risk that banks will not have withheld enough is reduced. Consequently, their responsibility to investigate the source of funding for all the interests in a jointly-held certificate of deposit is greatly lessened.

The new provision is also important for effective tax planning. This is the only type of gift that can be made within three years of death that will relieve the heirs from the burden of proving that it was not made in contemplation of death. Since the burden of proof can be almost insurmountable,[56] elderly persons and persons in poor health may best be advised to make gifts in the form of a joint interest in a certificate of deposit. Although the interest will be taxable if the Department of Revenue proves that the gift was made in contemplation of death, the likelihood of taxability is less than with any other form of gift.

III. SALES AND USE TAX

The major developments in Kentucky's sales and use tax were the addition of three exemptions and the Supreme Court's clarification of the exemption for new manufacturing equipment.

A. *Machinery for New and Expanded Use*

KRS § 139.480(8) exempts from the sales and use tax the sale of manufacturing and processing machinery for use in new

"[s]ums remaining on deposit at the death of a party to a joint account belong to the surviving party or parties as against the estate of the decedent unless there is clear and convincing evidence of a different intention at the time the account is created." KRS § 391.335 provides that "[a]ny sums in a joint account may be paid, on request, to any party without regard to whether any other party is incapacitated or deceased at the time the payment is demanded."

[56] *See* Chase's Ex'r v. Commonwealth, 145 S.W.2d 58 (Ky. 1940), where the burden was not overcome even though there was some history of similar gifts by the decedent.

and expanded industry. The most important qualification for the exemption is that the machinery be "used *directly* in the manufacturing or processing production process."[57] In two recent cases the Kentucky Supreme Court clarified this concept. In *Commonwealth v. Kuhlman Corporation,*[58] the Court explored the difference between equipment incorporated directly in the manufacturing process and that which performs supervisory or managerial functions. There the taxpayer installed a modern system of tracking the progress of jobs through its manufacturing plant and claimed a sales tax exemption for part of the system—a small computer located in a room separate from the manufacturing machinery. The computer's only link to the manufacturing process was by way of computer cards filled out by the workers. As these cards progressed with the various projects through the plant's manufacturing stages the workers would note on the cards when each stage was completed. At the end of each day the cards were collected and run through the computer.[59]

Because the computer was so divorced from the manufacturing process it was unnecessary for the Court to determine which factors it will rely on in deciding whether machinery is used directly in manufacturing. Thus in holding that the computer was not "machinery used directly in the manufacturing process"[60] the Court did not set out a clear test. Instead it simply noted that the computer did not control any manufacturing machinery nor did it manufacture anything itself.[61]

The second case, *Ross v. Greene & Webb Lumber Company,*[62] dealt with the question of when the manufacturing process begins and ends. In *Ross,* the Greene and Webb Lumber Company had been denied an exemption by the Department of Revenue for the purchase of forklifts. The forklifts were used both to carry lumber to a conveyor which carried the logs to their first milling process and to stack the logs after they were milled.[63] In holding that the equipment was directly in-

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[57] KRS § 139.170 (Supp. 1978) (emphasis added).

[58] 564 S.W.2d 14 (Ky. 1978).

[59] Commonwealth v. Kuhlman Corp., 564 S.W.2d 14, 15-16 (Ky. 1978).

[60] *Id.* at 15-16.

[61] *Id.* at 16.

[62] 567 S.W.2d 302 (Ky. 1978).

[63] Ross v. Greene and Webb Lumber Co., 559 S.W.2d 163 (Ky. Ct. App. 1977),

volved in manufacturing the Court defined the parameters of the manufacturing process:

> To conform to the legislative intent the manufacturing process should begin when the raw material (logs here) starts moving in a chain of unbroken, integrated sequence into the plant or mill and ends with a generally accepted saleable product. The machinery necessary and exclusively used in this chain should make up the machinery used directly in the manufacturing process.[64]

The Court's use of the words "exclusively" and "necessary" in the last sentence is *dictum* since no machinery was denied the sales tax exclusion because of those requirements. They are factors which have not previously been required for the new machinery sales tax exclusion. If the requirement that the machinery be exclusively used and necessary to the manufacturing process is taken literally by the Department of Revenue, it will be at least as important an addition to the Kentucky sales tax law as the test which hinges the tax upon where the manufacturing process will be considered to have begun and ended.

In a third case, *Department of Revenue v. Allied Drum Service, Inc.*[65] the Supreme Court of Kentucky expanded the scope of what constitutes manufacturing for purposes of the sales tax exemption of machinery purchased for a new or expanded industry. Because the General Assembly extended the machinery exemption to include all processing equipment rather than just equipment used in the manufacturing process,[66] the holding in *Allied Drum Service, Inc.* will only affect the exemption of purchases made before December 22, 1976.

Allied Drum was in the business of acquiring relatively worthless used metal drums and cleaning, reshaping, resealing and painting them.[67] Exemption of the machinery turned on

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aff'd, 567 S.W.2d 302 (Ky. 1978). The exemption of 13 other pieces of equipment was also contested by the Department of Revenue. These included a waste burner and conveyors used to carry waste to the burner, as well as others. *Id.* at 164-65. The Supreme Court of Kentucky held that "[a]ll the items are . . . exempt as being 'directly used in the manufacturing process.'" 567 S.W.2d at 304.

[64] *Id.* (quoting the trial court).

[65] 561 S.W.2d 323 (Ky. 1978).

[66] 1976 (Extra. Session) Ky. Acts ch. 7, § 1 (amending KRS § 139.170 (1970)).

[67] 561 S.W.2d at 324.

whether these activities constituted manufacturing. The Department of Revenue contended that because the process began with a drum and ended with a drum nothing was manufactured. Although the former Court of Appeals had used the same rationale in denying the exemption in several earlier cases[68] the Kentucky Supreme Court allowed the exclusion of the purchase price of Allied Drum's processing equipment. In doing so, the Court redefined manufacturing to constitute those processes whereby "[m]aterial having no commercial value for its intended use before processing has appreciable commercial value for its intended use after processing by the machinery."[69]

B. *Soybean and Grain Farming Equipment*

The 1978 General Assembly exempted the sale of any facility used on the farm in grain or soybean production from the sales and use tax.[70] This newly enacted provision applies to the purchase of replacement and repair parts as well as the purchase of the original facility. The preferred treatment is given to facilities used exclusively in the "storing, drying, processing, or handling"[71] of grain or soybeans. The wording of the exemption leaves unresolved the question of what kind of processing equipment can be installed on the farm property and be entitled to the exemption. Surely bakery equipment installed on the farm will not be exempt as on-farm processing equipment. This issue can probably best be resolved by restrictively interpreting the requirement that the facility must be an "on-farm facility."[72] The exemption should only apply to equipment used in ordinary farming operations. Equipment used for what is really a manufacturing or refining process should be considered off the farming premises and thus not exempt.

[68] In Prestonsburg Water Co. v. Prestonsburg Bd. of Suppliers, 131 S.W.2d 451, 453 (Ky. 1939), the Court of Appeals denied exemption of a water filtration system because the process began and ended with water and thus nothing was manufactured. Similarly, in City of Louisville v. Ewing Von-Allman Dairy Co., 105 S.W.2d 801, 803-4 (Ky. 1937), the Court of Appeals refused to exempt a milk pasteurizer.

[69] Dep't of Revenue v. Allied Drum Service, Inc., 561 S.W.2d 323, 325-26 (Ky. 1978).

[70] KRS § 139.480(12) (Supp. 1978).

[71] *Id.*

[72] *Id.*

C. *Energy Producing Fuels*

The 1978 General Assembly added a provision to exempt from the sales and use tax the sale of fuels used by agricultural machinery.[73] The exemption applies only to fuels used to "operate or propel"[74] tractors or farm equipment. Fuels used for lighting and heating farm facilities are not exempt. The exemption does not include wood or coal used to propel a steam engine but includes just about every other fuel.[75]

In addition, the General Assembly clarified an existing fuel exemption. KRS § 139.480(3) exempts from the sales tax those fuels used in "manufacturing, processing, mining, or refining" to the extent that the cost of the fuels exceeds three percent of the total cost of production. The old statute did not specify whether the total cost of production should be computed on the basis of each type of machine, each plant, or a series of processes performed at perhaps different plants but, when all combined, yield one identifiable product. Obviously a multi-process or multi-plant manufacturing concern's exemption would differ depending on the computation method used. This situation was clarified by adding to the exemption provision the requirement that the "[c]ost of production shall be computed on the basis of plant facilities which shall mean all permanent structures affixed to real property at one (1) location."[76]

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[73] KRS § 139.480(13) (Supp. 1978).

[74] *Id.*

[75] KRS § 139.480(13) provides that "[g]asoline, special fuels, and liquified petroleum gas" are excludable fuels. KRS § 138.210(4) (1971) defines gasoline to include:

> all liquid fuels, including liquids ordinarily, practically and commercially usable in internal combustion engines for the generation of power, and all distillates of and condensates from petroleum, natural gas, coal, coal tar, vegetable ferments and all other products so usable except propane, butane or other liquified petroleum gases, kerosene, cleaner solvent, fuel oil, diesel fuel and crude oil.

KRS § 234.100 provides that "'liquified petroleum gas' means and includes any material which is composed predominantly of any of the following hydrocarbons, or mixtures of them, whether in the liquid or in the gaseous states: propane, propylene, butane (normal butane or isobutane), and butylene." Special fuels include "all combustible gases and liquids capable of being used for the generation of power in an internal combustion engine to propel vehicles of any kind upon the public highways, except . . . gasoline . . . and liquified petroleum gas." KRS § 138.560(3) (1970).

[76] KRS § 139.480(3) (Supp. 1978) (*as amended* by 1978 KY. ACTS ch. 233, § 28).

D. *Textbooks*

Section 170 of the Kentucky Constitution provides that a non-profit educational institution's property cannot be taxed.[77] The Department of Revenue interprets this constitutional exemption to apply to a tax on the sale of property by the institution as well.[78] Thus the Department of Revenue has taken the position that the sale of textbooks by a non-profit school is exempt from the sales tax.[79] In 1970 the General Assembly enacted KRS § 139.474 to equalize the competitive positions of state-owned university bookstores and private textbook sellers.[80] It provided that state-owned university bookstores competing with privately operated college bookstores would be subject to the sales tax. Because the provision calling for taxation of sales by non-profit educational institutions directly conflicted with the Department of Revenue's interpretation of the Kentucky Constitution, the provision was repealed.[81] In 1978 the General Assembly adopted another approach to eliminating the competitive disadvantage. Instead of requiring taxation of sales by educational institutions, the new provision, KRS § 139.480(14), equalizes the tax treatment of the two types of bookstores by exempting both from the sales tax. The exemption, however, is limited to the sale of textbooks and other materials required for a course at a non-profit educational institution.[82] The sale of any item which is not specifically required of all students for a particular course, including "notebooks, paper, pencils, calculators, tape recorders, or other similar student aids"[83] is not exempt.

[77] "There shall be exempt from taxation . . ., 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." KY. CONST. § 170.

[78] KY. ADMIN. REG. SERV. SU-2(b) (1974).

[79] *See* Kennedy Book Store, Inc. v. Dept. of Revenue, 450 S.W.2d 524, 526 (Ky. 1970) (holding that the Department of Revenue's position was not arbitrary or unconstitutionally discriminatory). The Department of Revenue has also not taxed the sale of textbooks by distributors to schools even though KRS § 139.200 imposes the tax on the buyer and not the seller. Department of Revenue v. Kentucky Textbook, Inc., 555 S.W.2d 573, 574 (Ky. 1977). This may be because the transaction is not considered a "retail sale" for purposes of KRS § 139.100 or because the sale is expressly exempted by KRS § 139.470.

[80] 1970 KY. ACTS ch. 275, § 1.

[81] 1978 KY. ACTS ch. 258, § 3.

[82] KRS § 139.480(14) (Supp. 1978).

[83] *Id.*

IV. PROPERTY TAX

In addition to making numerous procedural changes, the 1978 General Assembly enacted a one and one-half cent per hundred dollars *ad valorem* tax on privately owned leasehold interests in government buildings.[84] The leasehold interest is taxable by the state but explicitly exempt from county and other local taxing authorities.[85]

V. COAL SEVERANCE TAX

The coal severance tax is now imposed not only on the value of coal at its extraction, but also upon its value as increased by post-severance processing.[86] Processing includes "cleaning, breaking, sizing, dust allaying, treating to prevent freezing, or loading for shipment."[87] However, merely loading coal which has not otherwise been treated in Kentucky is not a taxable process.[88]

The severance tax is imposed on the party with an economic interest in the coal.[89] Therefore, a party who merely contracts to process the coal but who has no ownership interest in the coal is not taxed. Instead the tax is placed on the owner who hired the processor.[90] The tax is levied on the difference between what a taxable processor received for the processed coal and what he paid for it.[91] The 4.5% tax rate is the same as that levied on the extraction of coal, except that the minimum tax of fifty cents per ton is not imposed on taxpayers who merely process coal.[92]

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[84] KRS § 132.020(1) (Supp. 1978) (effective Jan. 1, 1979).

[85] KRS § 132.200(8) (Supp. 1978).

[86] KRS § 143.020 (Supp. 1978).

[87] KRS § 143.010(8) (Supp. 1978).

[88] *Id.*

[89] KRS § 143.010(5) (Supp. 1978). Economic interest is defined to be:

> synonymous with the economic interest ownership required by Internal Revenue Code section 611 in effect on December 31, 1977, entitling the taxpayer to a depletion deduction for income tax purposes with the exception that a party who only receives an arm's length royalty shall not be considered as having an economic interest.

KRS § 143.010(10) (Supp. 1978).

[90] KRS § 143.010(5) (Supp. 1978).

[91] KRS § 143.010(6)(b)(2)(e) (Supp. 1978).

[92] KRS § 143.020 (Supp. 1978).

VI. UNIFORM GIFTS TO MINORS ACT

Kentucky's Uniform Gifts to Minors Act[93] provides a simplified procedure for giving income producing property to minor children. As a consequence, its enactment made income splitting[94] with minor children more convenient. A significant improvement in the mechanics of making such gifts was accomplished by the 1978 legislature with the enactment of KRS § 385.120, which permits testamentary bequests to a named custodian for the minor child. The new provision allows the transfer of the same kinds of property which the donor could have given during his lifetime.[95] The effects of such bequests are the same as with intervivos transfers, except for the necessity of passing through probate.

The 1978 General Assembly also acted to resolve an ambiguity in the Uniform Gifts to Minors Act. In 1976, the legislature redefined "minor"[96] as a person under eighteen, yet failed to change KRS § 385.041(4), which set twenty-one as the age when a custodian must turn the property over to a minor. This created an ambiguity as to when gifts must be turned over to a minor.[97] The principal reason for not changing the statutory age at which the property must be turned over to the donee was that many gifts had been made in contemplation of the donee receiving them at age twenty-one. Nevertheless, the 1978 General Assembly resolved the ambiguity by explicitly reducing to eighteen the age at which the custodian must turn over the property.[98]

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[93] KRS § 385.011-101 (1970).

If the gift consists of bank accounts, life insurance policies, annuity contracts, or securities in registered form the procedure is for the donor to register the property in the custodian's name "as custodian for [name of minor] under the Kentucky Uniform Gifts to Minors Act," or language with similar effect. KRS § 385.021(1)(a), (d) (1975). The custodian may be the donor himself, another adult or a trust company. KRS § 385.021(1)(a) (1975). If the securities are not in registered form, however, the statutory requirement is that the property be delivered to the custodian (an adult other than the donor or a trust company) accompanied by a statement of gift from the donor containing the language of custodianship. KRS § 385.021(1)(b) (1975).

[94] Splitting income provides a tax benefit to the family by virtue of the minor's lower tax bracket and utilization of his additional personal exemption against otherwise taxable income.

[95] *See* KRS § 385.110 (Supp. 1978).

[96] 1976 KY. ACTS ch. 16, § 7 (amending KRS § 385.011(13)).

[97] Whiteside and Buechel, *Kentucky Taxation*, 65 KY. L.J. 425, 433 (1976). (The authors consider the attempt by the legislature to lower the age provided in the Uniform Act to be misguided.)

[98] KRS § 385.041(4) (Supp. 1978).