

**COMMONWEALTH OF KENTUCKY
BOARD OF TAX APPEALS**

FILE NO. K09-R-27

HPCKAL, LLC

APPELLANT

VS.

ORDER NO. K-21182

**COMMONWEALTH OF KENTUCKY
FINANCE AND ADMINISTRATION CABINET
DEPARTMENT OF REVENUE**

APPELLEE

This matter came on for hearing on June 23, 2011 on HPCKAL's Motion for Summary Judgment. Having heard the arguments of the parties and the Board of Tax Appeals being otherwise sufficiently advised, the Board makes the following conclusions of Law:

BACKGROUND

Petitioner HPCKAL, LLC("HPCKAL") seeks to offset its income for 2005 and 2006 with the Net Operating Losses ("NOLs") it generated in 2002 and 2003. For the tax years ending prior to 2005, HPCKAL was treated as a pass-through entity, with all income and losses being passed through to its members. Prior to 2005, LLC members were permitted to carry forward any unutilized NOLs from a particular year to offset income in future years.

In 2005, the legislature passed Kentucky's Tax Modernization Act which amended the definition of "corporation" in KRS 141.010 to encompass virtually every type of business ,including LLCs. Effective January 1, 2005, the Department of Revenue began to tax pass-through entities, including LLCs, at the entity level, such that income and losses of an LLC were no longer passed through to the LLC members.

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HPCKAL attempted to use the NOLs in 2005 and 2006. The Department of Revenue sent HPCKAL a notice disallowing the use of NOLs generated by its assets in 2002 and 2003 on the basis that the Tax Modernization Act did not expressly permit an LLC to use NOLs from years prior to 2005 to offset income earned in 2005 and 2006. The NOLs, however, were not eliminated--they were left with the members who could have used the NOLs in 2005 and 2006 if they had had income in those years. HPCKAL had no NOL as of December 31, 2004--its members did.

In 2007, the legislature repealed the Tax Modernization Act and reinstated the taxation of LLCs at the member level and HPCKAL's members could utilize the remaining NOLs from 2002 and 2003 in 2007 and years thereafter.

CONCLUSIONS OF LAW

The change in the law under the Tax Modernization Act, effectively treated HPCKAL as if it had elected to be treated as a C corporation in 2004. While this change in the law was a clear one, even if there were any ambiguity in the statute, such ambiguity in the statute regarding HPCKAL'S ability to utilize NOLs belonging to its members, has to be resolved against HPCKAL. Statutes that grant tax exemptions, deductions or credits such as a net operating loss deductions are to be strictly construed with any doubts resolved against their application. Tennessee Gas & Transmission Co. v. Commonwealth, 308 Ky. 571, 215 S.W. 2d 102 (1948); Bigelow v. Reeves, 285 Ky. 831, 149 S.W.2d 499 (1941).

The Kentucky Supreme Court has also stated in the case of Finance and Administration

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Cabinet v. Johnson Controls, Inc., 296 S.W.3d 392, 397 (Ky. 2009) as follows:

It has been established that "a taxpayer has no vested right in the Internal Revenue Code" United States v. Carlton, 512 U.S. 26 (1994)(Nor, by comparison, is there a vested right in the Kentucky Revenue Code.)

In Johnson Controls, the taxpayers paid their taxes and were seeking a refund by amending their separate returns to a combined return under the unitary business concept for the years in question based upon the Supreme Court's earlier decision in GTE v. Revenue, 889 S.W.2d.788 (Ky. 1994), which held that related corporations could file a combined tax return under the unitary business concepts.

The legislature then amended the statutes to bar the type of combined return the taxpayers had filed and even barred their refund claims. The taxpayers claimed a property interest would be taken without due process of law if the amended statutes were allowed retroactive application to bar their refund claims. The Kentucky Supreme Court held that the amendments in question did not violate the taxpayers' due process rights and this decision was later upheld by the U.S. Supreme Court. Johnson Controls v. Miller, 130 S.Ct. 3324 (2010). Attorney Frankel, counsel for the taxpayers in this case, who was also counsel for the taxpayers in Johnson Controls, has argued that "HPCKAL by no fault of its own, has been caught in an unfair predicament as a result of this unusual legislative action."

Under the ruling of Johnson Controls, however, the taxpayers in this case have no vested right to use the NOLs for the years in question and the denial of the net operating loss deduction is appropriate as a matter of law. The NOLs must remain with the members and cannot transfer to HPCKAL for its use in 2005 and 2006.

ORDER

The Board affirms the Department of Revenue's final ruling and upholds the denial of the net operating loss deduction claimed by HPCKAL and the assessment of tax in the amount of \$2,530,063.00, plus applicable statutory interest.

However, based upon the brief time period between when the Tax Modernization Act was enacted and repealed, and based upon the specific facts of this case, the Board hereby denies the Department of Revenue's imposition of penalties.

This is a final and appealable order. All final orders of this agency shall be subject to judicial review in accordance with the provisions of KRS Chapter 13B. A party shall institute an appeal by filing a petition in the Circuit Court of venue, as provided in the agency's enabling statutes, within thirty (30) days after the final order of the agency is mailed or delivered by personal service. If venue for appeal is not stated in the enabling statutes, a party may appeal to Franklin Circuit Court or the Circuit Court of the county in which an appealing party resides or operates a place of business. Copies of the petition shall be served by the petitioner upon the agency and all parties of record. The petition shall include the names and addresses of all parties to the proceeding and the agency involved, and a statement of the grounds upon which the review is requested. The petition shall be accompanied by a copy of the final order.

A party may file a petition for judicial review only after the party has exhausted all administrative remedies available within the agency whose action is being challenged, and within any other agency authorized to exercise administrative review.

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A petition for judicial review shall not automatically stay a final order pending the outcome of the review, unless:

- (a) An automatic stay is provided by statute upon appeal or at any point in the administrative proceedings;
- (b) A stay is permitted by the agency and granted upon request; or
- (c) A stay is ordered by the Circuit Court of jurisdiction upon petition.

Within twenty (20) days after service of the petition of appeal, or within further time allowed by the Circuit Court, the KBTA shall transmit to the reviewing court the original or a certified copy of the official record of the proceeding under review in compliance with KRS 13B.140(3).

**DATE OF ORDER
AND MAILING: August 25, 2011**

**KENTUCKY BOARD OF TAX APPEALS
FULL BOARD CONCURRING**

**BILL HAYES
CHARIMAN**