RENDERED: SEPTEMBER 12, 2014; 10:00 A.M.
NOT TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2013-CA-000507-MR

OHIO VALLEY ALUMINUM COMPANY, LLC APPELLANT

v. APPEAL FROM SHELBY CIRCUIT COURT
HONORABLE CHARLES R. HICKMAN, JUDGE
ACTION NO. 12-CI-00368

DEPARTMENT OF REVENUE,
FINANCE AND ADMINISTRATION CABINET,
COMMONWEALTH OF KENTUCKY APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: ACREE, CHIEF JUDGE; MAZE AND STUMBO, JUDGES.

MAZE, JUDGE: Appellant, Ohio Valley Aluminum Company, LLC (hereafter "Ohio Valley"), appeals from the decision of the Shelby Circuit Court affirming the Kentucky Board of Tax Assessment ("the Board"). The Board previously declined to grant Ohio Valley's applications for a tax refund based on its asserted

status as a "toller" in the processing of scrap and raw aluminum and the resulting exemption from certain portions of Kentucky's Sales and School Taxes. As we find that Ohio Valley and its subsidiary, OVACO, are, in fact, one entity and therefore not entitled to the requested exemption, we affirm.

Background

I. Factual History

Ohio Valley is currently in the business of processing scrap and raw aluminum.[1] Historically, it purchased, sold and participated in hedging and speculation on the aluminum market. However, in 2007, in what it calls a "restructuring" necessary to "insulate its operation from … market volatility," Ohio Valley created a wholly owned subsidiary, OVACO. OVACO continued to purchase, sell, hedge and speculate while Ohio Valley transferred its entire inventory of raw materials and finished goods to OVACO and limited its business to the processing of aluminum.

Following the formation of OVACO, and pursuant to a subsequent "Tolling Agreement" between Ohio Valley and OVACO, Ohio Valley heated and processed all of OVACO's scrap aluminum and charged OVACO for the service. OVACO then sold the aluminum billets to various buyers. OVACO was Ohio Valley's only customer during the tax periods in question and the fees paid between them under the tolling agreement constituted Ohio Valley's only income.

---

[1] In this context, the term "processing" is best defined as receiving scrap aluminum, heating it, refining it, and forming it into aluminum billets, or rods, which are then sold to customers in the business of manufacturing or extruding various products.

In addition, Ohio Valley was OVACO's sole member; OVACO had no employees; and both companies comingled their assets in a single bank account owned by Ohio Valley's parent company, Interlock Industries, Inc.

II. Procedural History

Following the tax year ending on March 31, 2008, Ohio Valley petitioned the Department of Revenue ("the Department") for a tax refund based on its assertion that it was no longer required to include the cost of raw aluminum when calculating its cost of production for the purpose of determining its tax liability. Ohio Valley also petitioned for a refund for the tax year ending March 31, 2009, again asserting that it was exempt from including the cost of materials for purposes of such a calculation because OVACO, not Ohio Valley, owned the materials. As part of its evaluation of Ohio Valley's applications, the Department requested certain information regarding the two entities' relationship and operations. Following the exchange of this information, the Department denied both petitions and the matter proceeded to a hearing before the Board.

Following discovery and the development of an extensive record, the Board held an evidentiary hearing on January 17, 2012. Following the hearing, the Board determined that the cost of raw materials Ohio Valley processed must be included in its cost of production calculation because the respective operations of Ohio Valley and OVACO were not truly separate. The Board ultimately concluded that as a result of its indivisible operation alongside OVACO, Ohio Valley was not a true "toller" and was not entitled to a tax exemption and refund.

Ohio Valley appealed the Board's order to the Shelby Circuit Court which affirmed the Board's conclusions. This appeal follows.

Standard of Review

Ohio Valley challenges the Board's application of Kentucky's tax-related statutes and regulations to its business. Kentucky Revised Statutes (KRS) 13B.150(1) limits our review to the record from the Board unless there is an allegation of fraud or misconduct involving a party. No such allegation has been made, thus, we limit our review to the record as it existed before the Board. Furthermore, KRS 13B.150(2) permits us to affirm the Board's decision, or we may reverse and remand if we find its order

> (a) In violation of constitutional or statutory provisions;
> (b) In excess of the statutory authority of the agency;
> (c) Without support of substantial evidence on the whole record;
> (d) Arbitrary, capricious, or characterized by abuse of discretion;
> (e) Based on an ex parte communication which substantially prejudiced the rights of any party and likely affected the outcome of the hearing;
>
> (f) Prejudiced by a failure of the person conducting a proceeding to be disqualified pursuant to KRS 13B.040(2); or
> (g) Deficient as otherwise provided by law.

Regardless of the result we reach, we must not substitute our judgment for that of the Board "as to the weight of the evidence on questions of fact." *Id*. However, to the extent that the Board's decision concerns the construction and application of statutes, we review those matters of law *de novo*.

Louisville Edible Oil Products, Inc. v. Revenue Cabinet, Commonwealth, 957 S.W.2d 272, 274 (Ky. App. 1997) (citing to *Reis v. Campbell Co. Bd. of Educ.*, 938 S.W.2d 880 (Ky. 1996), and *Epsilon Trading Co., Inc. v. Revenue Cabinet, Commonwealth*, 775 S.W.2d 937 (Ky. 1989)).

Analysis

Ohio Valley's argument on appeal concerns two issues raised before the Board and the trial court. The first concerns whether Ohio Valley and OVACO are truly separate entities, and whether the answer to that question compels Ohio Valley to include the cost of raw materials in its cost of production calculation. Ohio Valley's second argument concerns its requests for a refund for the period from April to May of 2007 and whether the statute of limitations expired prior to those requests. We first address the statutes and regulations of importance in this case, as well as the true nature and tax consequences of the relationship between Ohio Valley and OVACO.

KRS 160.613 imposes on businesses a utility gross receipts license tax, or what is commonly referred to as the "school tax." The statute requires that the assessed tax is

> not to exceed three percent (3%) of the gross receipts derived from the furnishing, within the district, of utility services, except that "gross receipts" shall not include amounts received for furnishing energy or energy-producing fuels, used in the course of manufacturing, processing, mining, or refining to the extent that the cost of the energy or energy-producing fuels used exceeds three percent (3%) of the cost of production.

KRS 160.613(1). Similarly, KRS 139.310 imposes an excise tax, or "sales and use" tax, of six percent on tangible personal property. Like the "school tax," an exemption exists under this tax for

> [a]ll energy or energy-producing fuels used in the course of manufacturing, processing, mining, or refining … that are billed to the user, to the extent that the cost of the energy or energy-producing fuels used … exceed three percent (3%) of the cost of production.

KRS 139.480(3). The latter statute goes on to require that a company's cost of production be calculated "on the basis of plant facilities which shall mean all permanent structures affixed to real property at one (1) location." *Id.*

Again, Ohio Valley argues that OVACO, which it contends is a separate entity for tax purposes, is the owner of the raw aluminum it processes and, therefore, Ohio Valley is not required to include the value of the raw materials in its cost of production calculation. Ohio Valley contends that the difference between what it paid during the two years in question and its actual tax liability without the raw materials included in its cost of production calculation entitles it to a tax refund totaling $861,679. Thus, the paramount question is whether Ohio Valley and OVACO truly are separate entities for purposes of calculating cost. The answer to this question will determine whether Kentucky's tax statutes and regulations permitted Ohio Valley the refund it requested from the Department.

I. Construction of Tax Statutes and Regulations

Ohio Valley contends that its status as a fee processor, or a "toller," of raw materials owned by OVACO, prevents the Cabinet from requiring that it include the cost of those raw materials in the calculation of its cost of production. Thus, we must look to whether Ohio Valley truly is a separate entity from OVACO for purposes of taxation. To determine this, we look to several statutes and regulations, as well as case law which may guide our construction of both.

A. *Beam* and *Louisville Edible Oil Products*

In its opinion, the Board relied heavily upon our Supreme Court's decision in *Revenue Cabinet v. James B. Beam Distilling Co.*, 798 S.W.2d 134 (Ky. 1990). *Beam* concerned a taxpayer's application of its cost of production to only one of its three operations at the same location. The Court ultimately held that

> It seems only logical that a taxpayer which can demonstrate that the operation for which the exemption is claimed is a truly separate and complete operation not dependent on the other operations at that site for production of a complete project or process, need not include the costs of other unrelated operations in its costs of production for that one operation.

Beam at 135.

Ohio Valley contends in its brief that *Beam* does not apply because the case concerned a single taxpayer, whereas the present case concerns two. However, *Beam* concerns "the proper construction to be given" Kentucky's tax statutes and regulations; and Ohio Valley, like Beam, urges us "to interpret [KRS 139.480(3)] so as to permit a portion of its production costs … to be excluded or

disregarded altogether." *Louisville Edible Oil Products*, 957 S.W.2d at 275. Therefore, we conclude that the Board was correct in stating that *Beam* informs the analysis in this case.

In the above-cited *Louisville Edible Oil Products* case, the company seeking an exemption asserted, like Ohio Valley presently does, that because it merely processed a raw material on behalf of its customers, the cost of the raw material was not required to be included in its cost of production calculation. We disagreed, holding that the definition of "cost of production" found in 103 Kentucky Administrative Regulations (KAR) 30:140 provided "an inclusive, expansive interpretation" which encompassed "*all* costs, including raw material costs…." 957 S.W.2d at 274 (emphasis in original). Once again, Ohio Valley contends that *Louisville Edible Oil Products* does not apply because it addressed a single taxpayer. However, we again conclude, like the Board did, that the factual distinctions between that case and the present one do not prevent us from applying its useful reading of 103 KAR 30:140.

The Board concluded that Ohio Valley did not meet the standard in *Beam* because it had failed to show "that this aluminum casting operation, for which the partial energy exemption is sought, is a truly separate and complete operation from that of OVACO, and that Ohio Valley is not dependent on OVACO…." We agree.

In the language of *Beam*, Ohio Valley and OVACO are dependent upon one another for the production of a finished product. The record reflects that

without OVACO, Ohio Valley would have had no customers during the time period in question; and without Ohio Valley's processing services, under the separate entity scheme it presently professes, OVACO could not have produced a heated and refined aluminum billet. Therefore, unlike the bourbon in *Beam*, some of which was warehoused and packaged by third-party entities, the aluminum owned by OVACO would not be a marketable product without Ohio Valley's processing of it; a service which OVACO exclusively reserved for Ohio Valley.

Furthermore, even if Ohio Valley's function within the corporate arrangement it professes is limited to the processing of a raw material, the "inclusive, expansive interpretation" of "cost of production" provided by 103 KAR 30:130 and endorsed in *Louisville Edible Oil Products* requires the inclusion of "*all* raw material costs when computing 'cost of production.'" 957 S.W.2d at 274 (emphasis in original). Under the current facts, this would include the raw aluminum owned by OVACO. The guidance in the above cases, as well as the language of our statutes and regulations, permit no other conclusion.

B. *Babcock* and "Substance Over Form" Analysis

Ohio Valley takes exception with another analysis the Board employed in its ruling, the so-called "substance over form" analysis. In *Revenue Cabinet v. Babcock and Wilcox Co.*, 203 S.W.3d 149 (Ky. App. 2005), we held that a company's "reserve account," set aside for payment of pending product liability claims, was taxable only to the extent that it was not offset by actual possible liability stemming from those claims. In doing so, we acknowledged that

"it is the duty of courts to look to the substance rather than the form of a transaction, and the rule applies with equal force to matters of taxation." *Babcock*, 203 S.W.3d at 156. This doctrine looks to "the economic realities of a transaction rather than to the particular form the parties employed." *Frank Lyon Co. v. United States*, 435 U.S. 561, 573, 98 S.Ct. 1291, 1298, 55 L. Ed. 2d 550 (1978). More simply, the principle of substance over form focuses on what actually takes place between two entities rather than the formal legal steps the parties take to achieve the tax result. The doctrine is in place to prevent the creation of two identical economic situations, *i.e.*, identical processes, income, tax liability, etc., which are nonetheless taxed differently because of the actions taken to achieve that end.

Ohio Valley argues that the Board misapplied or "erroneously relied on" our analysis in *Babcock* because that case did not deal with Kentucky's sales or school taxes. Those taxes, Ohio Valley asserts, are "form-driven taxes." Indeed, the facts of *Babcock* are distinguishable from those of the present case. However, Ohio Valley asks us to abandon the "substance over form" doctrine while providing us with no authority which requires or suggests that we do so. In the absence of such authority for Ohio Valley's assertion to the contrary, we see no reason to abandon the "substance over form" analysis.

Applying *Babcock*, we agree with the Board that the allegedly separate relationship between Ohio Valley and OVACO does not withstand scrutiny. Despite its status as a wholly owned subsidiary, OVACO was Ohio Valley's only customer during the tax periods in question and the fees paid

between them under the tolling agreement constituted Ohio Valley's only income. In addition, Ohio Valley is OVACO's sole member, OVACO has no employees, and both companies comingle their assets in a single bank account owned by Ohio Valley's parent company, Interlock Industries, Inc. From this Court's perspective, these facts reveal not two distinct companies, but a single company which has attempted to limit its tax liability by dividing the same processes, *i.e.,* hedging, purchasing, selling, and processing and tolling, between a parent company and a subsidiary which exists merely on paper.[2]

"It is a well-accepted rule of construction that exemptions from taxation are disfavored and that such statutes are to be strictly construed against the taxpayer." *Beam*, 957 S.W.2d at 276 (citing to *Delta Air Lines v. Revenue Cabinet*, 689 S.W.2d 14 (Ky. 1985)). "Moreover, the cardinal rule of statutory construction is to give effect to discernible legislative intent." *Id*. (citing to *McCracken Co. Fiscal Court v. Graves*, 885 S.W.2d 307 (Ky. 1994). The intent of our General Assembly in permitting the exemptions in KRS 139.480 and 160.613 was, in part, "to encourage the location and expansion of industries in Kentucky." *Beam*, *supra*, at 135. We agree with the Department that this intent is not served by permitting a company, which has merely transferred assets to a subsidiary that

[2] We do not foreclose companies' ability to limit their tax liability. Indeed, "there is no legal prohibition against a taxpayer using legitimate methods to avoid taxation." *Collins v. Kentucky Tax Comm'n*, 261 S.W.2d 303, 306 (Ky. 1953) (citing to *Trinity Temple Charities, Inc., v. City of Louisville*, 188 S.W.2d 91 (Ky. 1945)). "But … if the taxpayer's ingenuity fails at any point[,] the courts should not resolve the doubt in his favor." *Id*. (citing to *Morsman v. Commissioner of Internal Revenue*, 90 F.2d 18, 113 (8th Cir. 1937)).

employs no one and expands no element of its operation, to claim exemptions to which it would not otherwise be entitled. Rather, giving proper effect to the legislative intent behind KRS 160.613(1) and KRS 139.310, as well as 103 KAR 30:140 – an intent which the cases we cite and the "substance over form" doctrine aim to preserve – we once again strictly construe those provisions to disfavor an exemption.

C. The Department of Revenue's Internal Policy

We briefly discuss an additional issue which Ohio Valley raised in attacking the Board's analysis regarding its cost of production calculation. Ohio Valley makes much of the fact that the Department of Revenue's Training Manual provides

> A paper company that is created to appear to be a procurement company but which results in no change to an entity's previous business operations, accounting records, or tax returns, will not be accepted as a viable applicant ….

Ohio Valley contends that this policy violates KRS 13A and that the Board and the circuit court erred in relying on this policy as a basis for denying Ohio Valley's application for an EDPA. Once again, we disagree.

We first observe that the trial court's alleged reliance on the Department's internal policy actually resembles mere mention of it; and the Board did not reference the policy even once in its opinion. Therefore, we are hard-pressed to believe either entity "relied" on the policy or used it to form the backbone of the preceding orders. More importantly, both the Board and the trial

court found other grounds for their respective orders; specifically, that the statutes, regulations, and case law cited *supra* justified the denial of Ohio Valley's applications. As we have already stated, we agree with this conclusion and we find no error in the trial court's reference to the Department's internal policy, as that policy is bolstered by binding authority.

II. April and May 2007 Refund Requests

Finally, having determined that Ohio Valley was not entitled to any refund due to its relationship with OVACO, its claim that the trial court erred in finding that the statute of limitations had run on its request pertaining to April and May of 2007 is moot. Hence, we do not address this claim.

Conclusion

We hold that the Board was correct in concluding that Ohio Valley and OVACO are, in fact, one entity for purposes of taxation, and that the Board did not err in denying them recognition as otherwise. Therefore, the decision of the Shelby Circuit Court is affirmed.

ALL CONCUR.

BRIEF FOR APPELLANT:

Michael Grim
Brent R. Baughman
Mark A. Loyd
Louisville, Kentucky

BRIEF FOR APPELLEE:

Bethany Atkins Rice
Frankfort, Kentucky