Wait, They Can Do That? The Perils of Policy Changes by Departments of Revenue

Apr 16, 2020

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Blogs
Tax Law Defined™ Blog

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Authority and Role of Department of Revenue's Interpretation of the Law

One of the basic rules you learn in law school is the hierarchy of authorities at both the Federal and state level. The Constitution is the law of the land, with statutes (and regulations) being the next levels of authority, and then there's case law developed by various levels of judicial and quasi-judicial bodies. But an important element of the above, especially in the tax world, is how state tax departments of revenue interpret these authorities as the majority of disputes in the SALT arena arise from the gray areas of tax law – where a department's longstanding interpretation and enforcement of same can become the deciding factor, both negatively and positively.

There is no question that for SALT practitioners and professionals, the more guidance the better when trying to interpret and apply complex tax statutes and regulations in our day-to-day practices, and likewise just as important to taxpayers looking to make business decisions based on their understanding of these laws. So, clear guidance from departments of revenue charged with interpreting and administering tax law is unquestionably a good thing for the tax and business community, and when such interpretations are longstanding, they can become "policy" and become part of the fabric of the law and thus can be relied upon by taxpayers as binding authority.

That's one reason tax transparency has been such a hot topic the past several years, because no one wants "secret law" created and capriciously enforced by taxing agencies. But with great power, comes great responsibility, and if these agencies essentially have the ability to create law through their interpretations and set policy based on same, then they also have a responsibility to not change

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these interpretations/policies arbitrarily, secretively or retroactively as a matter of law, or at the various least, pursuant to basic fairness and constitutional protections.

But, inevitably, many of us have seen firsthand such a change in policy by state (and local) tax agencies occur during audits, rulings and the like which has negatively affected a client or business. This article explores defenses that can be raised against such changes in policy and how these issues are continuing to be challenged in various states.

Basic Arguments Against DOR Changes to Interpretations and Policies

In any situation in which you believe a taxing agency has reversed its prior interpretation or enforcement of a tax law, you must go back to the authority hierarchy we discussed – starting with constitutional protections. Nearly every state has some type of equal protection and/or uniformity requirements for a government to enforce the laws of the state uniformly and fairly, and thus it can be credibly argued that a taxing agency has directly violated such protections when it treats one taxpayer differently from another similarly situated taxpayer.[1] The Federal Equal Protection Clause has long been held to protect against "taxation which in fact bears unequally on persons or property of the same class"[2], so don't be afraid to allege such actions have occurred at the protest-level, and beyond, when the taxing agency has intentionally changed its interpretation and enforcement of the tax laws which has the effect of treating similarly situated persons differently and unfairly. Likewise, most states have some sort of state constitutional uniformity protections for taxpayers that prohibits the state's exercising of arbitrary power and classifications to prevent unreasonable discrimination when one person is being taxed and another is not.

Another argument that goes hand-in-hand with these constitutional protections is the basic principles of fundamental fairness – often called the "square corners" argument. Simply put, a taxing agency has a duty of consistency and fair dealing and may not change its policies until it has notified the taxpayer that a new policy will be

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applied for future years.[3] This principle has its origins from then-U.S. Supreme Court Justice Oliver Wendell Holmes stating that "men must turn square corners when they deal with the Government," with the Supreme Court later acknowledging that this principle must also protect taxpayers, as most recently expounded upon but the Sixth Circuit that: "Common honesty and good conscience require that taxpayers receive ordinary fair play from tax officials. While men must learn to turn square corners when they deal with the government,…'there is no reason why the square corners should constitute a one-way street.'"[4] Any actions to the contrary may not only be fundamentally unfair, but rise to the level of manifest injustice if egregious enough – another doctrine that has become increasing popular in the SALT context.[5]

Next on the hierarchy is statutory protections. Most states, at the very least, have some form of Taxpayer Bill of Rights, which requires fair and equitable treatment, as well as the department fully explaining all policies, procedures, and obligations of taxpayers. But many states have gone one step further to protect taxpayers by enacting statutes which explicitly prohibit their respective taxing agencies from changes to its policies. For example, Indiana statutorily prohibits a change in the department's "interpretation" (e.g., ruling, letter of finding, directive, bulletin, etc.) of an enumerated tax prior to the change being adopted in a formal rule or made publicly available on the Indiana Register if the change would increase a taxpayer's liability.[6]

Mississippi is another example because although it does not have a single statute prohibiting such actions, it instead has multiple statutory provisions that accomplish this goal, including prohibiting the assessments of sales tax in a current audit if the taxpayer's methodology for same was previously audited and resulted in no tax due[7], as well as in the income tax arena to prohibit the department of revenue from forcing combined affiliated corporations "until regulations have been enacted specifying the criteria and circumstances" requiring same.[8]

And keeping with this rule against *retroactive* changes in policy, Missouri likewise statutorily prohibits any final decision of the department of revenue which is the result of a change in policy or

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interpretation affecting a particular class of person from being applied retroactively.[9]

Along these lines, while some states may not statutorily prohibit these specific actions, many states do have statutorily-based administrative procedures that must be followed before a taxing agency's interpretations can become enforceable law. In these states, taxpayers are armed with another formidable defense – that a taxing agency's interpretation of the law does *not* have the force and effect of law, and does not receive deference, if isn't created through a formally promulgate regulation or the applicable rulemaking process, and when such formal procedures have not been followed, any internal policy created violates these statutory protections.

Kentucky, for example, has a very detailed version of an Administrative Rulemaking Procedure Act which requires strict rulemaking procedures be followed by state agencies[10], and because of same, courts have consistently struck down policies developed by the department of revenue over the past several decades.[11] Massachusetts provides another example as its statutes prevent any change in policy by the department of revenue unless the change is first publicly announced to taxpayers pursuant to the promulgation of a regulation or issuance of technical information release, directive, administrative procedure or other similar guidance regarding this change in policy, and such change cannot apply to tax periods prior to the public announcement of same (i.e., cannot be retroactive).[12] This statutory prohibition came about after a prior Massachusetts Supreme Court decision strongly criticized the department's administrative flip-flopping.[13]

And finally, at the next hierarchy level, many states have judicially-developed rules which prevent a taxing agency from changing its interpretations of the law and policies resulting from same in certain situations. My home state of Kentucky actually has multiple judicially-created rules to prevent such actions by the department of revenue, including what is known as the Doctrine of Contemporaneous Construction which makes clear that a longstanding interpretation of the law can eventually become so

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ingrained with the fabric of the law, that it itself becomes the law and thus the Department is barred from unilaterally or retroactively changing such policy. Although taxpayers have claimed many victories over the years under this doctrine, Kentucky courts continue to rule on both sides of the issue, as seen in recent Kentucky court decisions (discussed more below).

New Mexico has a similar rule called the Doctrine of Administrative Gloss which binds the taxing agency when there are multiple instances (e.g., audits) or any publication that demonstrates the policy. This doctrine was created out of a state supreme court decision which has continued to develop and expand ever since to, at the very least, deprive the department of revenue from a presumption of correctness or deference when it attempts to attack a position that it accepted in prior audits.[14] Another example is Utah whose rule originates after its Supreme Court agreed that a longstanding (twenty year) interpretation and application of the law by its tax commission becomes the law unless it is clearly contrary to a plain reading of the statute, and any change must be applied prospectively pursuant to a statute or formal rule.[15] And yet another example can be found in Missouri which has an "unexpected decision" statute to prevent unfair decision against taxpayers.[16]

Likewise, many states have statutes, or judicially recognized rules, which emphasize that a taxing agency is a "creature of statute" and thus while it can interpret the law, it cannot add to, detract from or place additional conditions or limits to a statute.[17] Thus, a department's policy can be challenged if it attempts to go beyond what the law allows.

All of these authorities independently, and collectively, can become a very powerful tool for taxpayers, and their tax representatives, to push back against reversals in policy by state and local taxing agents during audits (after past audits permitted treatment of certain transactions/items with no change in law or fact), when a refund claim is denied on items previously granted for the taxpayer or a similarly situated taxpayer, and when prior rulings by a taxing agency for one taxpayer are found to be contrary to a more recent ruling for the same or similarly situated taxpayer. Unfortunately, this

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is not an uncommon occurrence in the SALT world, and such policy changes are not always intentional or devious, as younger/more inexperienced auditors and supervisors simply may not have the institutional knowledge of their predecessors to be aware of prior rulings/determination as many of these longtime department employees begin to retire.

So, what is to be done about the issue? As stated, increased transparency is one way in which these issues will hopefully begin to work themselves out as taxpayer obtain more access to prior rulings and guidance from taxing agencies. But many states will likely continue to deal with these issues on a case-by-case basis through litigation, while others will pursue enactment of statutes or constitutional amendments to explicitly bar such actions, as recently exemplified in Kentucky, Tennessee and Florida.

Kentucky, Tennessee and Florida Provide Different Examples of How These Changes to Policies Continue to be Addressed Across the Country

As discussed above, Kentucky's Doctrine of Contemporaneous Construction stands for the proposition that an interpretation of a statute made by an administrative agency, including the department of revenue, once made and applied over a long period of time, cannot be unilaterally revoked by the agency.[18] But this not a bulletproof defense, as Kentucky and other states have recognized that a change in a long-standing statutory interpretation can be made on a *prospective*, rather than retroactive, basis.[19] Other limitations to such defense also exist, as the doctrine can generally only be utilized when the underlying statute/law is ambiguous in some manner which allows courts to resort to such a rule of statutory construction.[20] Three recent, but unpublished (and thus nonprecedential), Kentucky court decisions have ruled differently on this doctrine.

First, in Progress Metals, the Court determined that the department of revenue's longstanding policy of recognizing liquid oxygen was an exempt industrial supply (as a cutting tool) which could be shown in

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the department's past internal, administrative manuals, was enough for the Court to hold for the taxpayer.[21] The same Court, however, was again forced to deal with this doctrine earlier this year and instead decided that it did *not* apply in World Acceptance Corp., despite the department of revenue previously issuing an informal ruling (via email as Kentucky only recently created a formal ruling process) to the taxpayer regarding which entities were to be included in a consolidated return, as well as the existence of a similar ruling for another taxpayer.[22] The Court instead believed that "two rulings issued over a five-year span do no constitute a long-standing 'policy' that falls within the contemporaneous construction."[23] Thus, in additional hurdle to using this doctrine not previously focused on is now highlighted – whether the agency's interpretation has been around long enough, or formal enough, to be considered a longstanding "policy." But what if it could be shown that there was another ruling or written determination by the Department (informal or not) on this issue ten years prior too – would that be enough to demonstrate a policy? This is the gray area we continue to live in on a daily basis.

But yet an even more recent example can be seen in a Kentucky lower court decision just a few month ago regarding the taxability of another industrial supply, fire brick, in Novelis v. Dep't of Revenue.[24] Although the court did not go so far as to apply the doctrine of contemporaneous construction in Novelis, it did rely on principles of fairness when it took note that two prior audits of the taxpayer exempted these refractory materials in support of its decision that such items were covered by the applicable exemption statute. The department of revenue, however, chose not to appeal such decision to the Court of Appeals – was this decision done in part to protect the more recent anti-doctrine of contemporaneous construction decision in World Acceptance Corp.? It's entirely possible, but we will never know for sure.

While the battle over the Doctrine of Contemporaneous Construction will continue to rage on in Kentucky, as will battles in other states with similar judicially created limitations to a taxing agency's ability to change its policies, other states have instead tried to prevent such litigation by enacting statutes which explicitly prevents such unfair actions. Tennessee is an example of this

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strategy as it already has a statute on the books which prevents the department from a retroactive change in policy, but as has become a common problem in most of these states, the statute does not define or elaborate on what constitutes a "policy" of the department. Given continuous disputes between taxpayers and the department over this statute (e.g., whether it applies to audits which are by their very nature, for past years and thus retroactive) and what constitutes a new "policy" or interpretation, both sides have been actively engaged in a potential statutory change which would provide more parameters to this rule for clarity purposes, but an agreement on the exact language is still being debated.

Last, Florida is a rather unique situation as the department of revenue has taken the position that it does not make policy (only the legislature does), and thus no statute has ever been enacted to prevent unfair reversals or changes in tax policies. Instead, Florida voters approved Amendment 6 to its state constitution late last year, which became effective in January 2019, to require state court judges and administrative law judges to interpret state statutes and regulations *de novo*, or anew, without deferring to an administrative agency's interpretation of the law.[25] This constitutional amendment ended Florida's longstanding doctrine of judicial deference to agency interpretation of the law, which had become an increasing problem over the years for taxpayer fairness and uniformity purposes.

The jury is still out on which of the above strategies is the best approach for states to help prevent unfair, retroactive changes in policy by departments of revenue. The good news is that the word is out, and just like tax transparency the past several years, hopefully in the near future, we will no longer be saying "Wait, can they do that," and instead saying "Wait, they used to be able to do that?" But until then, we will continue to fight the good fight.

For more information please contact Daniel Mudd or any attorney in Frost Brown Todd's Tax practice group. For up to date information on tax-related issues, visit the Tax Law Defined Blog.

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attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

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[1] *See e.g.*, Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526 (1959); Avery v. Midland County, Tex., 390 U.S. 474, 497 (1968); Mississippi State Tax Comm'n v. Trailways Lines, Inc., 567 So. 2d 228 (Miss. 1990) (overturning an assessment against a taxpayer that was inconsistent with a widely shared agreement the department reached with another taxpayer based on general principles of equal protection and uniformity).

[2] Allegheny Pittsburgh Coal Co. v. County Comm'n of Webster County, W. Va., 488 U.S. 336, 343 (1989).

[3] *See e.g.*, Revenue Cabinet v. Caster Knott Dry Goods Co., Civil Action No. 92-CI-0160 (Franklin Cir. Ct. 1992) *aff'g* Order No. K-14398, File Nos. K90-R-31 & 34 (KBTA 1991); Chapperal Coal Corp., et al. v. Revenue Cabinet, File Nos. K89-R-1086 & 1088 (KBTA 1991); Conway Import Co. v. United States, 311 F. Supp. 5 (E.D.N.Y. 1969); Willamette Valley Lumber Co. v. United States, 252 F. Supp. 199 (D.C. Or. 1966).

[4] *See* Rock Island A. & L.R. Co. v. United States, 254 U.S. 141 (1920); Federal Crop Insurance Corp. v. Merrill, 332 U.S. 380, 388 (1947) ("there is no reason why the square corners should constitute a one-way street"); Interstate Fire Insurance Company v. United States, 215 F. Supp. 586, 600 (E.D. Tenn. 1963), *aff'd* 339 F.2d 603 (6th Cir. 1964).

[5] *See* Oberhand v. Dir., Div. of Tax'n, 193 N.J. 558, 940 A.2d 1202 (2008); Kennecott Utah Copper Corp. v. Utah State Tax Comm'n, 87 P.3d 751 (Utah Ct. App. 2004).

[6] Ind. Code 6-8.1-3-3(b).

[7] MS 27-65-37(1).

[8] MS 27-7-37.

[9] Mo. Ann. Stat. § 32.053.

[10] *See* KRS 13A.100(1) (any administrative statement, policy, memorandum or other writing which "implements; interprets' [or]

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prescribes law or policy" by an agency "shall" (i.e., must) be done through the promulgation of a formal administrative regulation, by following all procedural requirements, including notice and comment to the public and review by legislative committees). *See also*, KRS 13A.020-13A.350; KRS 13A.350. Therefore, in Kentucky, any sort of policy, guidance, memorandum, standard or directive by an administrative agency, including the department, does not have the force and effect of law unless such a writing has been duly promulgated and filed pursuant to KRS 13A.100. *See* Flying J Travel Plaza v. Com., 928 S.W.2d 344, 347 (Ky. 1996); Ctr. Coll. v. Trzop, 127 S.W.3d 562, 566 (Ky. 2003).

[11] *See e.g.*, Revenue Cabinet v. Humana, Inc., No. 96-CI-00609 (Franklin Cir. Ct., Div. I 1997); *aff'd*, 998 S.W.2d 494 (Ky. App. 1998).

[12] M.G.L. c. 62C § 26(j) (added by St.1998, c. 485, §11).

[13] Commissioner of Revenue v. Baybank Middlesex, 421 Mass. 736, 739-743 (1996).

[14] High Ridge Hinkle Joint Venture v. City of Albuquerque, 126 N.M. 413, 416, 970 P.2d 599, 602 (NM 1998).

[15] *See* Snarr Advertising v Tax Commission, 432 P2d 882 (Utah 1967).

[16] Mo. Ann. Stat. § 143.903.

[17] *See e.g.* GTE v. Revenue Cabinet, 889 S.W.2d 788, 791 (Ky. 1994) ("An administrative agency cannot add or detract from a statute by promulgating a policy of regulation."); Ruby Constr. Co. v. Dep't of Revenue, 578 S.W.2d 248, 252 (Ky. App. 1978) ("[A]n administrative agency may not seek to amend, alter, enlarge, or limit terms of legislative enactment"); Ex parte Uniroyal Tire Co., 779 So.2d 227 (Ala. 2000); Ins. Com'r of State of Md. v. Bankers Indep. Ins. Co., 326 Md. 617, 624, 606 A.2d 1072, 1075 (1992); Trump–Equitable Fifth Ave. Co. v. Gliedman, 57 N.Y.2d 588, 457 N.Y.S.2d 466, 443 N.E.2d 940 (N.Y. Ct. App.1982); Delaware Alcoholic Beverage Control Comm'n v. Newsome, 690 A.2d 906, 911 (Del. 1996); Espinoza v. Montana Dep't of Revenue, 2018 MT 306, ¶ 44, 393 Mont. 446, 469, 435 P.3d 603, 615, cert. granted, 139 S.Ct. 2777 (2019); David v. David, 287 Va. 231, 240, 754 S.E.2d 285, 290 (Va. 2014). *See also*, KRS 13A.130(1) ("an

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administrative body *shall not* by internal policy, memorandum, or other form of action: (a) modify a statute or administrative regulation; [or] (b) expand upon or limit a statute or administrative regulation").

[18] *See e.g.,* GTE v. Revenue Cabinet, 889 S.W.2d 788, 792 (Ky. 1994); Hagan v. Farris, 807 S.W.2d 488 (Ky. 1991); Grantz v. Grauman, 302 S.W.2d 364 (Ky. 1957); Paducah Marine Ways v. Revenue Cabinet, 730 S.W.2d 956 (Ky. App. 1987).

[19] *See e.g.*, KRS 446.080; Shaw v. Seward, 689 S.W.2d 37 (Ky. App. 1985); Peach v. 21 Brands Distillery, 580 S.W.2d 235 (Ky. App. 1979); Commonwealth v. General Elec. Co., 372 S.E.2d 599 (Va. 1988); R & P Serv. v. Commonwealth, Dep't of Revenue, 541 A.2d 432 (Pa. 1988).

[20] *See e.g.*, GTE, *supra* n. 17, at 792.

[21] Progress Metal Reclamation Co. v. Dep't of Revenue, 2015 WL 1197545 (Ky. App. 2015) (unpublished).

[22] World Acceptance Corp. v. Dep't of Revenue, 2019 WL 103961, No. 2015-CA-001852 (Ky. App. Jan 4, 2019) (unpublished).

[23] Id. at 11.

[24] Novelis Corp. v. Dep't of Revenue, Civil Action No. 16-CI-00189 (Madison Cir. Ct. Jul. 2, 2019), *rev'g* File Nos. K13-R-35; K14-R-22, Order No. K-25052 (KBTA 2016).

[25] Art. V, §21, Fla. Const. ("SECTION 21. Judicial interpretation of statutes and rules.—In interpreting a state statute or rule, a state court or an officer hearing an administrative action pursuant to general law may not defer to an administrative agency's interpretation of such statute or rule, and must instead interpret such statute or rule de novo").

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