New Local Taxes on the Menu in Kentucky? Kentucky Court Considers Constitutionality of Local Restaurant Tax

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Is the Kentucky General Assembly's population-based statutory structure for permitting a city to impose a local restaurant tax unconstitutional as applied to certain localities? That was the question at the heart of *City of Hazard, et al. v. Commonwealth of Kentucky, et al.*, in which the Franklin Circuit Court agreed KRS 91A.400, as currently written, was unconstitutionally arbitrary. And could this case set the table for future local tax reform? This article provides an overview of this recent decision, as well as potential implications for the longstanding debate over local tax reform in Kentucky.

Kentucky Revised Statue 91A.400 and 2014 HB 331

The central issue before the Franklin Circuit Court in *City of Hazard* was whether KRS 91A.400 is constitutional. The City of Hazard ("Hazard") argued that this statute was "unconstitutionally arbitrary" because it restricted the class of cities eligible to enact a restaurant tax on the basis of population and fixed the city's classification as of January 1, 2015, when the statutory amendment was made.[1] Hazard argued that these classifications were discriminatory to cities similarly situated with identical population criteria and taxation needs.

For context, in 1980, acting under the authority from Section 156 of the Kentucky Constitution, which authorized the creation of then six (6) classifications of cities, the General Assembly passed KRS 91A.400 allowing cities in the fifth class to impose up to a 3% tax upon all retail sales made by restaurants within their jurisdiction. Later, in 1986, the General Assembly amended the statute to also allow cities of the fourth class to enact the referenced restaurant

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tax.[2]

This classification system remained in effect until after the 1994 ratification of Section 156A, which authorized the General Assembly to "create such classifications of cities as it deems necessary based on population, tax base, form of government, geography, or any other reasonable basis and enact legislation relating to the classification." Then, in 2014, the General Assembly adopted House Bill (HB) 331, which eliminated the previous classification of cities and replaced it with two classifications: first-class cities and home rule cities pursuant to newly created KRS 81.005 (effective January 1, 2015); it *also* amended KRS 91A.400 to allow the restaurant tax to be imposed by "authorized cities."

The Struggle with HB 331 and the *New* classifications

Due to the 2014 amendment to KRS 91A.400 by HB 331, an authorized city is one that "as of January 1, 2014 [was] classified as [a] cit[y] of the fourth or fifth class."[3] In other words, only cities classified as fourth- or fifth-class cities based on "frozen-in-time population figures" can enact this restaurant tax, while other cities, such as Hazard, which was still classified as a third-class city under these statutory thresholds, were prohibited from doing so.

According to Section 156 of the Kentucky Constitution of 1891, fourth-class cities were those with a population between 3,000 and 7,999 people. Hazard has always qualified as a fourth-class city population-wise, but the General Assembly mistakenly misclassified Hazard in the past (under Section 156) and never correctly labeled it as a fourth-class city for purposes of the restaurant tax under KRS 91A.400. Because of this, Hazard asked for certain judicial remedies in this case, including being reclassified as a fourth-class city for the purpose of KRS 91A.400.

Hazard's Arguments

Hazard argued that KRS 91A.400 violates the Kentucky Constitution, including: Section1 (rights to life, liberty, and redress of grievances), Section 2 (prohibition on arbitrary governmental action), Section 3

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(equal protection), Section 4 (power inherent in the people to reform government), Section 59 (prohibition on local and special legislation), Section 60 (General law not to be made special or local by amendment—No special powers or privileges—Law not to take effect on approval of other than General Assembly—Exceptions), and Section 156A (General Assembly authorized to provide creation, governmental structure, and classification of cities).

Of these arguments, the most important to note are the violations of Sections 2 and 3 of the Kentucky Constitution. Regarding Section 2, Hazard asserted that KRS 91A.400 created a "list of special/favored cities based on a repealed and defunct system of classification of cities."[4] Moreover, Hazard argued that the statute arbitrarily selects classification that was held by a city on January 1, 2014,[5] including as follows:

KRS 91A.411 does not allow for any consideration of either population growth, decline or error in the analysis as to which cities are allowed the restaurant tax income. KRS 91A.400 does not provide a means for cities to migrate from one class to another. KRS 91A.400 does not provide a means for a new group of Kentucky residents to form a new city that could benefit from KRS 91A.400. There is no reason which can justify why only one city in a group of cities which are the same size can impose restaurant tax.[6]

Beyond its Section 2 arguments, Hazard argued that the statute failed both strict scrutiny and rational basis constitutional reviews under Section 3 of the Kentucky Constitution and the Equal Protection Clause of the Fourteenth Amendment of the United States Constitution.[7]

However, Hazard did not simply request these statutes be stuck down, but rather, it suggested a remedy to this issue by asking the court to judicially remove the impermissible statutory restrictions—e.g., severing the word "authorized" in the third sentence of the statute to allow Hazard to be classified as a fourth-class city.[8]

The Attorney General's Rebuttal

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On the flip side, the Kentucky attorney general argued that Hazard was precluded from bringing the constitutional challenge because it failed to plead more than one generalized grievance, with no concrete and particularized injury. Further, the attorney general argued that this lack of standing was caused by the failure to publish the full text of the Section 156 constitutional amendment when voters decided its enactment at the ballot box.[9] Additionally, the attorney general bolstered its argument that Hazard failed to establish standing for the constitutional challenge to Section 156A by conceding that they "were not directly injured by the ratification of Section 156A. Instead, it is the effect of KRS 91A.400…that have caused harm."[10]

The attorney general also argued that even if Hazard can establish standing, the Franklin Circuit Court should decline to consider the challenge to Section 156A due to the Doctrine of Laches because Hazard "failed to amend their complaint to include a Section 156A challenge until the Commonwealth, in its original motion to dismiss, explained that KRS 91A.400 is a proper exercise of the legislative authority granted to the General Assembly by Section 156A."[11]

Scanning the Menu: The Court's Analysis

The Franklin Circuit Court boiled the issue down to whether KRS 91A.400 makes an arbitrary classification of cities based on population totals on a fixed date frozen in time, notwithstanding changes in population and circumstances. Agreeing with the defendant and intervening cities,[12] the court found that rational basis scrutiny was the best standard of review.

To begin its analysis, the Franklin Circuit Court looked at Hazard (a city that is ineligible to enact the restaurant tax) *and* similarly situated cities, which are eligible to levy the KRS 91A.400 restaurant tax. Hazard, with a population of 5,425, is barred from imposing the tax, but cities like Greenville (population 4,528) and Beaver Dam (population 3,555) are eligible and have benefited from the tax.[13] While the court agreed that, generally, this sort of population classification would be reasonable, here it was arbitrary because populations change but there is no statutory ability to reclassify cities based on same.[14] Thus, the court held that the language of

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KRS 91A.400 does not provide "[a] mechanism to reclassify cities that migrate into or out of population ranges of cities in the 4th and 5th class range, and further offers no pathway to correct issues of mistaken classification for cities like Hazard which should have been re-classified as a 4th class city on January 1, 2024."[15] With cities like Beaver Dam and Greenville, the Franklin Circuit Court determined the classification is solely based on "frozen-in-time" population figures, rendering KRS 91A.400 unconstitutional because it is both under-inclusive and over-inclusive.

The court also took issue with the over- and under-inclusiveness of the statute as, for example, Elizabethtown (population 31,394) is classified as a fourth-class city that can enact the restaurant tax while a city like Richmond (population 34,585) cannot. Similarly, while Elizabethtown can levy the tax, smaller cities like Hazard, Paducah, Hopkinsville, Frankfort, Henderson, and Jeffersontown cannot.[16]

As it found KRS 91A.400 to be an arbitrary classification and constitutionally impermissible, the court did not address other claims brought by Hazard under Sections 3, 4, 59, 60, and 156A of the Kentucky Constitution.

Initial Conclusion and the Court's Actions

The Franklin Circuit Court concluded in its initial order dated May 13, 2024, that KRS 91A.400 is unconstitutional in how it permits cities to enact the restaurant tax. Further, the court stated that the statute fails to provide a pathway to correct the misclassification of cities like Hazard that should be a fourth-class city (instead of its current classification as a third-class city). The court did not hold the entire statute unconstitutional, but instead utilized a rarely applied judicial remedy of severing portions of the statute that violate a section of the Kentucky Constitution, as follows:

[T]he Court ORDERS the severance of §1 and §2, as well as the word "authorized" in §3 of KRS 91A.400. Additionally, the Court ORDERS that the Governor's Office of Local Government include on the list of cities eligible to impose the restaurant tax on all similarly situated cities, like Ashland, with population

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ranges within the parameters of 4th and 5th class cities. The Court does not disturb KRS 91A.400 authority granted to cities like Elizabethtown to enact the restaurant tax even though its current population far exceeds the population of 8,000 that capped 4th class cities under the now repealed Section 156.

The court then directed the Governor's Office of Local Government to include Hazard on the list of cities eligible to impose the tax.

On Second Thought …

After Judge Shepherd's initial order, in response to motions for an amended order, the Franklin Circuit Court agreed that its decision was written unnecessarily broad and issued an amended order dated August 15, 2024, applying solely to Hazard as it was not brought as a class action, *but importantly leaving the door open for other cities to bring similar claims*.

Ready for the Check, or Want the Dessert Menu?

Although this case is currently on appeal at the Kentucky Court of Appeals,[17] as stated, it not only provides a roadmap, and an opening, for other similarly situated/affected cities that are stuck in the 2014 KRS 91A.400 classification to bring additional causes of action to allow them to impose a local restaurant tax, but it could also force a more serious discussion on local tax reform generally, which has been debated in Kentucky for many years.

As background, the Kentucky Constitution limits the revenue that local jurisdictions may attain through taxation, primarily having to rely on property taxes and the occupational license tax (OLT) to fund their jurisdictions. While the OLT, which is a two-part "license fee" on net profits or gross receipts and payroll earned in the jurisdiction, can be lucrative for some jurisdictions, over time, it has not proven to be an exceptionally reliable source of revenue and has been criticized for years for making Kentucky less business-friendly.

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As we have written about previously,[18] given this limitation, there have been several attempts to pass legislation to authorize local tax reform in Kentucky for decades, including the removal of the OLT in exchange for permitting local sales taxes or similar consumption-based taxes, etc., but nothing has ever managed to make it past the General Assembly. Could the concern over more cities being able to impose a local restaurant tax pursuant to *City of Hazard* cause 2025, or more likely 2026 (when there is a full legislative session), to be the year it finally moves forward? Only time will tell, but it could be enough for the locals to ask for some off-the-menu options that legislators may be willing to cook up.

Please reach out to the authors of this article if you have questions or concerns on this issue. You can also continue to follow Frost Brown Todd's Tax Law Defined® Blog for more updates.

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[1] *City of Hazard, et al. v. Commonwealth of Kentucky, et al.*, Order Granting Summary Judgment and Declaratory and Injunctive Relief, No.23-CI-82 (2024).

[2] 1986 Ky. Acts ch. 203 §1, effective July 15, 1986.

[3] *Id.*

[4] *See Pl.'s Mem. In Supp. Of Mot. For Summ. J. Decl. KRS 91A.400 as Unconstitutional.*

[5] *Id.*

[6] *Id.* at 27.

[7] *Id.*

[8] *Id.*

[9] *Def.'s Reply in Supp. Of Mot. To Dismiss*, filed October 3, 2023.

[10] *See Def.'s Reply in Supp. Of Mot. To Dismiss, supra* at 3.

[11] *Id.* at 6.

[12] While the Franklin Circuit Court does not discuss it in great detail, it is important to note that other cities joined the Commonwealth of Kentucky as defendants in this case. One in particular is the city of Elizabethtown.

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[13] The Court examined several other cities, with larger and smaller populations that have enacted the restaurant tax. The other cities mentioned are Paintsville (population4,312), Oak Grove (population 8,019), Grayson (population 3,758), Williamsburg (population 5,342), and Pikeville (7,924).

[14] *City of Hazard, et al. v. Commonwealth of Kentucky, et al.*, Order Granting Summary Judgment and Declaratory and Injunctive Relief, No.23-CI-82, at 15-16 (2024).

[15] *Id.*

[16] *See Pl.'s Mem. In Supp. Of Mot. For Summ. J. Decl. KRS 91A.400 as Unconstitutional.*

[17] *See* 2024-CA-0629 (Ky. App.).

[18] *See* Frost Brown Todd's *Tax Blog* articles on this subject, including https://fbtgibbons.com/new-local-tax-reform-bill-in-the-commonwealth/ ; https://fbtgibbons.com/kentucky-tax-talk-budget-focus-cools-tax-reform-efforts/ ; and https://fbtgibbons.com/expansion-of-local-tax-legislation-introduced/ .

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