



**FINANCE AND ADMINISTRATION CABINET  
OFFICE OF THE SECRETARY**

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**John R. Farris**  
Secretary

In the matter of:

██████████ CORPORATION

Contact: ██████████  
Director of Domestic Taxes  
██████████ Corporation

████████████████████  
████████████████████

FINAL RULING NO. 2006-109  
November 2, 2006

Corporation Income and License Tax Assessments For  
Tax Periods Ended May 31, 2001 Through May 31, 2003

**FINAL RULING**

The Kentucky Department of Revenue (the "Department"), formerly the Revenue Cabinet, has issued assessments of additional corporation income and license tax for the May 31, 2001 through May 31, 2003 tax periods. The audit of the tax periods was performed by the Multistate Tax Commission (the "MTC"). Tables detailing the tax, penalty and interest, calculated through November 1, 2006, due to the Commonwealth of Kentucky are as follows:

**Corporation Income Tax<sup>1</sup>**

YEAR	TAX	FEE	INTEREST	TOTAL
May 31, 2002	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████
<b>TOTAL</b>	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████

**Corporation License Tax**

TAX	TAX	PENALTY	FEE	INTEREST	TOTAL
May 31, 2001	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████
May 31, 2002	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████
May 31, 2003	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████
<b>TOTAL</b>	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████	\$ ██████████

<sup>1</sup> The original corporation income tax assessment for the period ending May 31, 2002 was for \$ ██████████, plus statutory interest and fees. A portion of the assessment (\$ ██████████ in tax, plus statutory fees and interest), related to the change in the apportionment factor was not protested.

In addition, for the corporation income tax periods ending May 31, 2001 and May 31, 2003, the MTC audit adjusted the amount of the loss reported for those years. The amount of the loss for May 31, 2001 was adjusted from (\$████████) to (\$████████). Of that amount, \$████████ of the adjustment is related to a change in the apportionment factor, and a disallowance to certain other deductions, which were not protested. The amount of the adjustment relating to protested issues is \$████████. The amount of the loss for May 31, 2003 was adjusted from (\$████████) to (\$████████). Of that amount, \$████████ of the adjustment is related to changes in the depreciation adjustment and extraterritorial income, which were not protested. The amount of the adjustment relating to protested issues is \$████████.

### CORPORATION INCOME TAX

There are two remaining unresolved issues pursuant to █████████ Corporation's ("████████'s") letter of protest regarding the corporation income tax assessments. The first issue is an adjustment made by the MTC for the May 31, 2002 and 2003 tax periods, where certain taxes that were deducted on █████████'s federal income tax return were added back to determine Kentucky income. In response to this adjustment, █████████ claimed that the MTC had added back all taxes, regardless of whether the taxes were based on income, and that █████████% of the MTC adjustment in fact related to franchise tax paid to Pennsylvania. Further, █████████ stated the █████████ taxes are not based on gross or net income and therefore not subject to being taxed by Kentucky.

KRS 141.010(13) provides that:

"Net income," in the case of corporations, means "gross income" as defined in subsection (12) of this section minus the deduction allowed by KRS 141.0202, minus any amount paid for vouchers or similar instruments that provide health insurance coverage to employees or their families, and minus all the deductions from gross income allowed corporations by Chapter 1 of the Internal Revenue Code and as modified by KRS 141.0101, except the following:

- (a) Any deduction for a state tax which is computed, in whole or in part, by reference to gross or net income and which is paid or accrued to any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or to any foreign country or political subdivision thereof;

However, █████████'s claim that all taxes were added back that were deducted on the Federal Form 1120, regardless of whether they were income-based or not, is incorrect. For example, for the year ending May 31, 2003, the adjustment was based upon Statement 2, attached to the pro forma separate federal return for █████████. This new total equaled \$████████ and consists of

\$████████ in state taxes based on income, and \$████████ in foreign taxes. Other items contained on Statement 2 to the pro forma return, such as state taxes based on net worth, sales and use taxes, business licenses, permits, payroll taxes, property taxes and non-income based taxes, totaling \$████████, were not included in the adjustment. As a result, the MTC adjustment is proper, as only income based taxes and foreign taxes were the only items included in the adjustment, as is consistent with KRS 141.010(13).

Moreover, on ██████████ 2005, and ██████████ 2006, the Department requested a schedule reflecting a breakdown of taxes based on gross or net income. ██████████ failed to respond to this request. On ██████████, 2006, the Department attempted to schedule a conference to discuss this matter. ██████████ also failed to respond to this request. As a result, ██████████ has failed to provide any documentation supporting its contention that non-income based taxes were included in this adjustment, or to otherwise explain how the classification of taxes contained in the statement to its own pro forma separate federal return is incorrect.

The second corporation income tax issue involves an adjustment to income based on a calculation of expenses related to non-taxable income. Since actual expenses were not available, the MTC employed method # 3 from Revenue Policy 41P150 to determine expenses related to non-taxable income. Revenue Policy 41P150 provides that:

If actual expenses, such as interest, salaries, general and administrative and other stewardship expenses, cannot be related directly to such income, a formula must be used. The formulas recognized by the cabinet are as follows:

- (1) Ratio of nonbusiness/nontaxable assets to total assets times interest expense. Interest expense represents all expenses incurred in the stewardship or maintenance of nonbusiness or nontaxable assets. Other expenses may be used which more fairly reflect expenses attributable to the income or assets producing the nonbusiness/nontaxable income. Assets must be valued at cost and the investment account must exclude equity;
- (2) If the total nonbusiness/nontaxable income does not exceed fifty percent (50%) of the total gross receipts, the expenses not deductible in method one (1) above may be reduced proportionably but not to exceed fifty percent (50%) of the calculated expenses;
- (3) One and seventy-five hundredths of a percent (1.75%) of the cost of assets producing nonbusiness/nontaxable income;
- (4) Ratio of nonbusiness/nontaxable income to total gross receipts times interest expense, officers' salaries, and general

administrative expenses. The sum of these or any reasonable combination of these expenses; and

(5) A flat percentage—one percent (1%) to one hundred percent (100%) -- of nonbusiness/nontaxable income. The percentage used must be reasonable and reflect the expenses attributable to the stewardship or maintenance of the assets producing such income.

Moreover, KRS 141.010(13)(d) provides that:

"Net income," in the case of corporations, means "gross income" as defined in subsection (12) of this section minus the deduction allowed by KRS 141.0202, minus any amount paid for vouchers or similar instruments that provide health insurance coverage to employees or their families, and minus all the deductions from gross income allowed corporations by Chapter 1 of the Internal Revenue Code and as modified by KRS 141.0101, except the following:

(d) Any deduction directly or indirectly allocable to income which is either exempt from taxation or otherwise not taxed under the provisions of this chapter, and nothing in this chapter shall be construed to permit the same item to be deducted more than once;

████████ contends that no expenses should be attributable to the non-taxable income, as the non-taxable income consists of foreign dividends, most of which are deemed dividends. ██████████ further suggests in its protest that first, any expenses incurred are already charged back to the subsidiary, second, that one employee spends about two months of their time on deemed dividends, and third, that no direct or indirect expenses are incurred with respect to this income, nor put forth an alternative method to better estimate the expenses associated with this income. However, ██████████ has neither provided any evidence showing what those actual charge-backs or expenses are, or how there are no expenses, in light of the first two arguments, or put forth an alternative method that may better estimate the expenses associated with this income. As a result, there has not been sufficient documentation provided to the Department showing that this adjustment should be changed.

## LICENSE TAX

████████ has protested the Department's assessment, asserting that the Department exceeded its authority under KRS Chapter 13A with its definition of surplus in 103 KAR 20:020, Section 1 (16). Specifically, "surplus" is defined as "the excess of the net assets of a corporation over its capital stock." 103 KAR 20:020(16), Section 1. ██████████ argues that the definition of surplus should instead be controlled or defined by generally accepted accounting principles ("GAAP").

However, the Department has not exceeded its statutory authority, nor has it contradicted KRS 136.070 in promulgating 103 KAR 20:020(16). The regulatory definition of “surplus” is consistent with the definition set forth by the Kentucky Court of Appeals in The Kroger Co. v. Department of Revenue, 614 S.W.2d 705 (Ky. App. 1981). In that case, the court specifically held that:

It appears from the briefs and argument of counsel that under generally accepted accounting principles the money carried as deferred taxes would not be considered capital for accounting purposes. Nevertheless, our concern must be with what the statute requires, not with what accounting practices require, no matter how correct those practices may be as a matter of accounting principles.

Id. at 708 (citations omitted). Moreover, the Kroger court held that surplus is the excess of the net assets of a corporation over the par or stated value of its corporation stock. Id. ████████ has not challenged the mathematical accuracy of this adjustment, only the statutory authority to make this adjustment in the first place. As a result, the adjustment was correct and in accordance with both the Kroger decision and 103 KAR 20:020, Section 1 (16).

This letter is the final ruling of the Department.

### APPEAL

You may appeal this final ruling to the Kentucky Board of Tax Appeals (the “Board”) pursuant to the provisions of KRS 131.110, KRS 131.340-131.365, 103 KAR 1:010 and 802 KAR 1:010. If you decide to appeal this final ruling, your petition of appeal must be filed at the principal office of the Kentucky Board of Tax Appeals, 128 Brighton Park Boulevard, Frankfort, Kentucky 40602-2120, within thirty (30) days from the date of this final ruling. The rules of the Board, which are set forth in 802 KAR 1:010, require that the petition of appeal must:

1. Be filed in quintuplicate;
2. Contain a brief statement of the law and facts in issue;
3. Contain the petitioner's or appellant's position as to the law and facts; and
4. Include a copy of this final ruling with each copy of the petition of appeal.

The petition of appeal must be in writing and signed by the petitioner or appellant. Filings by facsimile or other electronic means shall not be accepted.

Proceedings before the Board are conducted in accordance with 103 KAR 1:010, 802 KAR 1:010 and KRS 131.340-131.365 and KRS Chapter 13B. Formal hearings are held by the Board concerning the tax appeals before it, with all testimony and proceedings officially reported. Legal representation of parties to appeals before the Board is governed by the following rules set forth in Section 2 (3) of 802 KAR 1:010:

1. An individual may represent himself in hearings before the Board;
2. An individual who is not an attorney may not represent any other individual, corporation, trust, estate, or partnership before the Board; and
3. An attorney who is not licensed to practice in Kentucky may practice before the Board if he complies with Rule 3.030(2) of the Rules of the Kentucky Supreme Court.

You will be notified by the Clerk of the Board of the date and time set for any hearing.

Sincerely,  
FINANCE AND ADMINISTRATION CABINET  
DEPARTMENT OF REVENUE



THOMAS H. BROWN  
Director  
Division of Protest Resolution

CERTIFIED MAIL  
RETURN RECEIPT REQUESTED

