



1. Paid \$██████████ in cash in exchange for ██████████ Preferred shares, which were converted into ██████████ common stock on a ██████████-to-██████████ ratio at the time of the initial public offering in 1997.
2. Granted ██████████ a \$██████████ loan convertible into an additional ██████████ shares of common stock, which note was converted on a ██████████-to-██████████ ratio in 1997.
3. Received a warrant to acquire ██████████ shares (██████████ shares after stock splits) at \$██████████ per share, which ██████████ exercised in 1998 by payment of \$██████████.

In connection with the acquisition of ██████████ shares, ██████████ executed the License and Technical Assistance Agreement with ██████████, which granted ██████████ an exclusive license to use ██████████ (██████████) technology in commercial wireless applications. This license also provided that ██████████ could not produce similar products without ██████████'s permission. In exchange for the technology license, ██████████ received ██████████ common shares. ██████████ also entered into a Supply Agreement with ██████████ in 1996 to purchase certain minimum quantities of ██████████ from ██████████.

██████████ developed and patented ██████████ technology in connection with contracts to develop high-speed communications for the U.S. military. Certain major original equipment manufacturers were interested in using components based on this technology in their next generation cellular handsets, but only if there was adequate fabrication capacity to meet high-volume production requirements. ██████████ did not possess the required fabrication capacity, and for this, and other reasons, ██████████ decided not to directly enter the commercial semiconductor market.

██████████ had a strong presence in the developing cellphone commercial market place, but did not have a wafer production capability. Therefore, as part of acquiring an ownership interest in ██████████, ██████████ licensed the ██████████ technology to ██████████, which used ██████████'s \$██████████ cash investment to build a plant to produce ██████████. This plant was completed and production began in ██████████ 1998.

At issue is whether ██████████ correctly classified the gain on the sale of an equity interest in ██████████.

The Department classifies the gain on the sale of assets as either business to nonbusiness income in accordance with KRS 141.120(1)(a) and (e) and Regulation 103 KAR 16:060.

KRS 141.120(1)(a) states:

"Business income" means income arising from transactions and activity in the regular course of a trade or business of the corporation and includes income from tangible and intangible property if the acquisition,

management, or disposition of the property constitutes integral parts of the corporation's regular trade or business operations.

KRS 141.120(1)(e) states:

“Nonbusiness income” means all income other than business income.

Regulation 103 KAR16:060 Section 5(2) states in part:

Gains or Losses from sale of assets. As a general rule, gain or loss from the sale, exchange or other disposition of real, tangible, or intangible personal property is business income if the property was used by the corporation to produce business income...

Gains on the sale of assets, because of their nomenclature, are not automatically classified as nonbusiness income. Each item must be examined to determine if it should be classified as nonbusiness.

It is ██████████'s position that the gain on the sale of the equity interest in ██████████ was properly classified as nonbusiness pursuant to both the transactional and functional tests.

The Department disagrees with ██████████'s assertion that these two tests are not met, based on the facts and circumstances of this case, which include:

- ██████████ held a significant portion of outstanding stock (██████%) in ██████████.
- An employee of ██████████ sits on the board of ██████████.
- ██████████ granted ██████████ a loan of \$██████████.
- ██████████ granted ██████████ an exclusive licensing agreement to manufacture and use ██████████ (██████████) technology in commercial wireless applications.

The Department's position is that, based on Kentucky law and the facts of this case, ██████████ has an interest in ██████████, that this interest is significant, ██████████ would not have granted ██████████ the exclusive right to produce and use the ██████████ wafers without this interest, and therefore, the income from the gain on the sale of ██████████ is correctly classified as business income.

Since the Department determined that ██████████ incorrectly classified the gain on the sale of an equity interest in ██████████ as non-business income for the 1999 and 2001 tax periods, the resulting reclassification affected the Kentucky Net Operating Loss Deductions (KNOLD) for all years of the examination and a correction must also be made to the KNOLD. This is the final ruling of the Department of Revenue.

### APPEAL

You may appeal this final ruling to the Kentucky Board of Tax Appeals 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 Kentucky Board of Tax Appeals, 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 Kentucky Board of Tax Appeals 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



THOMAS H. BROWN  
Director  
Division of Protest Resolution

CERTIFIED MAIL  
RETURN RECEIPT REQUESTED

