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Governor

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JONATHAN MILLER
Secretary

THOMAS B. MILLER
Commissioner

In the matter of:

[redacted] Co.
[redacted] Company

Contact: [redacted]
[redacted] Inc.
[redacted]
Corporate Tax Dept. [redacted]
[redacted]

FINAL RULING NO. 2009-11
January 14, 2009

Corporation Income and License Tax Assessments For
CYE December 31, 2003 through December 31, 2004

FINAL RULING

The Kentucky Department of Revenue (the "Department") has issued assessments of additional corporation income and license tax for calendar years ending ("CYE") December 31, 2003 through December 31, 2004. The following table details the tax, interest and penalty calculated through January 14, 2009 due to the Commonwealth of Kentucky.

[redacted] Co

Tax Period	Tax	Interest	Penalty/Fees	Totals
Income Tax				
12/31/2003	[redacted]	[redacted]	[redacted]	[redacted]
12/31/2004	[redacted]	[redacted]		[redacted]
Totals	$[redacted]	$[redacted]	$[redacted]	$[redacted]
License Tax				
12/31/2003	[redacted]	[redacted]	[redacted]	[redacted]
12/31/2004	[redacted]	[redacted]		[redacted]
Totals	$[redacted]	$[redacted]	$[redacted]	$[redacted]

[redacted] Company

Tax Period	Tax	Interest	Penalty/Fees	Totals
Income Tax				
12/31/2003	[redacted]	[redacted]	[redacted]	[redacted]
12/31/2004	[redacted]	[redacted]		[redacted]
Totals	$[redacted]	$[redacted]	$[redacted]	$[redacted]
License Tax				
12/31/2003	[redacted]	[redacted]	[redacted]	[redacted]
12/31/2004	[redacted]	[redacted]		[redacted]
Totals	$[redacted]	$[redacted]	$[redacted]	$[redacted]

[redacted] Co. ("[redacted]") and [redacted] Co. ("[redacted]"; collectively [redacted] and [redacted] are referred to as "Taxpayers") are Kentucky corporations who operate coal mining operations both within and without Kentucky. Prior to the tax years in dispute, both Taxpayers owned synthetic fuel manufacturing facilities, and supplied those facilities with [redacted] from their own [redacted] reserves.

Beginning in 2003, [redacted] Corporation, Taxpayers' parent corporation, decided to take advantage of a Section 29 Federal Credit for Synfuel. As part of that process, a new entity, [redacted] LLC ("[redacted]"), a [redacted] Limited Liability Company, was created, and through a series of corporate structurings, the synthetic fuel assets owned by Taxpayers were ultimately transferred to [redacted] in exchange for certain ownership interests.[1] On April 1, 2003, an unrelated party, [redacted], LLC purchased 50% of the interest in [redacted] for cash consideration.[2] The Taxpayers received a distributive share from the gain on this sale.

Subsequent to the transfer, various agreements were entered into regarding the sale of coal from Taxpayers to [redacted]. In addition, Taxpayers entered into an agreement with [redacted] where they agreed to furnish manpower, repairs and maintenance to [redacted]'s synfuel facilities in exchange for certain compensation.

The result of this transfer, for Kentucky tax purposes, was that [redacted] and [redacted] now sold coal to [redacted] (such sales were Kentucky sales), who in turn converted the coal into synfuel and sold it to customers both within and without the state. However, when filing their tax

[1] The restructurings, according to Taxpayers, worked as follows: On [redacted], 2003, Taxpayers contributed their synthetic fuel plants assets to [redacted], LLC ([redacted]), a [redacted] LLC. In exchange [redacted] received a [redacted]% interest in [redacted], and [redacted] received a [redacted]% interest in [redacted]. That same day, [redacted], 2003, [redacted] contributed all of its assets to [redacted] for a [redacted]% interest in [redacted].
[2] Subsequent to this, additional interests were sold to unrelated third party investors, until [redacted] owned only a [redacted]% interest in [redacted] and the unrelated third party investors owned [redacted]% of [redacted].

returns, Taxpayers reported the synfuel sales by [redacted] to customers within and without the state as sales by Taxpayers, not [redacted], to the customers. Taxpayers wish to somehow disregard their sales of coal, which are all Kentucky sales, to [redacted] for purposes of computing their Kentucky sales factor, even though [redacted] is a separate legal entity (and an unrelated third party owned [redacted]% of [redacted] beginning [redacted], 2003, and Taxpayers' ownership in [redacted], via [redacted] only continued to decline, as additional interests to unrelated third party investors were sold).

After the returns were filed, the Office Audit Section of the Corporation Tax Branch ("Office") made adjustments to the apportionment factor, specifically the sales factor, which affected the calculation of the Taxpayers' corporation income and license tax liability. The Taxpayers sought to use an alternative apportionment method with respect to the sales, and Taxpayers' representatives admitted reducing the Kentucky sales from the Taxpayers to [redacted] on their CYE December 31, 2003 return. The request for alternative apportionment was denied by the Office, and the eliminated sales and the distributive share income from [redacted] were added back to the sales factor for both Taxpayers pursuant to KRS 141.206(6).

A review of the CYE December 31, 2004 return by the Office revealed that the Taxpayers had taken the same approach in both 2003 and 2004. The Taxpayers supplied the Office with the amount of Kentucky sales that had been eliminated from the CYE December 31, 2004 apportionment factor. The returns for that year were adjusted by adding back the eliminated sales to the sales factor for both Taxpayers pursuant to KRS 141.120(8)(c) and KRS 136.070(3)(d).

In response to this adjustment, Taxpayers argue that either their initial treatment of the sales on the tax returns should be allowed, or in the alternative, they should be granted an alternative apportionment method which would allow them to exclude the sales, which are all Kentucky sales, to [redacted] from their sales factor (both the numerator and denominator). Taxpayers argue that such treatment is justified because they believe that, but for the restructuring, Taxpayers' Kentucky sales apportionment factor for 2003 and 2004 would have been the same as it was for the three years prior to the restructuring. It is unclear, however, how there could be "no substantive change" as argued by Taxpayers, when an unrelated third party took a [redacted]% ownership interest in [redacted] and the synthetic fuel assets, and ultimately, unrelated third parties combined to hold a [redacted]% ownership interest in [redacted]. Moreover, with respect to the Taxpayers' desire to eliminate the sales of coal as intercompany sales, assuming arguendo that the ownership interest gives rise to the sales being treated as intercompany sales, Kentucky law does not permit the filing of a consolidated or combined partnership return where intercompany transactions of partners are eliminated.

Similarly, with respect to Taxpayers' request for an alternative apportionment method, alternative apportionment is a limited remedy that is to be granted only "[i]f the allocation and apportionment provisions of this section do not fairly reflect the extent of the corporation's business activity in this state . . . ." KRS 141.206(9)(a). A similar test is contained in KRS

136.070(4) for corporate license tax. Taxpayers have failed to demonstrate, based on the facts presented to date, that the inclusion of the sales of coal from Taxpayers to [redacted] in their apportionment factor fails to fairly reflect the extent of their business activity (or capital) in Kentucky, particularly in light of the ownership structure of [redacted].

The second issue involves the distributive share from the gain on the sale of membership interests in [redacted] to unrelated third parties by the Taxpayers. Upon receipt, Taxpayers elected to record 100% of the gain in the year of sale, even though the sales were "installment" sales and the amount to be paid under such sales was ultimately dependent on the level of annual synfuel production. Taxpayers were entitled to make such an election. As it turns out, Taxpayers, in a later tax year (which is not part of this final ruling), will ultimately not receive part of this gain, due to the increase in oil prices, resulting in a capital loss. At the end of the day, the decision to take the gain upfront was a voluntary business decision by the Taxpayers, even if the hoped for tax benefits, in hindsight, failed to materialize. Taxpayers believe that the gross receipts related to this gain, even though this sale was to an unrelated third party, should be excluded from the numerator and denominator of their sales factor. In the alternative, Taxpayers seek an alternative apportionment method excluding the distributive share from inclusion in the receipts.

However, Kentucky follows the federal treatment of a partnership as a nontaxable entity, a conduit where the income, deductions, credits, etc., flow through to the partners, based on their distributive net shares. This arrangement between companies or individuals is taxed as an intangible for Kentucky state income tax purposes. In accordance with KRS 141.206(6), "Resident partners, S corporation shareholders and corporations which are partners in a multistate partnership or shareholders in a multi-state S corporation are taxable on one hundred percent (100%) of the distributive share of income, gains, losses, deductions or credits."

Taxpayers also argue that to treat the sales of coal from Taxpayers to [redacted], and the distributive share income from [redacted], via [redacted] to Taxpayers, constitutes double taxation. However, double taxation does not exist here. The sale of coal is taxed once, and the income generated by [redacted] does not result from the same sale of the coal. With respect to any distributive share income derived from the sales of the synfuel, Taxpayers argue that there is only "one" transaction and "one" customer, but the situation in this case is no different than when a supplier sells to a manufacturer, and the manufacturer turns around and sells to the ultimate customer. There is simply more than one step in the process, with separate transactions. Moreover, in this case, while Taxpayers repeatedly assert that nothing has changed, the fact of the matter is that [redacted] beginning in [redacted], 2003, and increasingly since then, was owned by unrelated third party investors, not the Taxpayers. Similarly, to the extent the distributive share income was derived from the sale of ownership interests in [redacted] to outside third parties, again, that transaction is separate and apart from the sale of the coal to [redacted] by Taxpayers.

As discussed above, Taxpayers have failed to demonstrate, based on the facts presented to date, that the inclusion of the distributive share income in their sales factor fails to fairly reflect the extent of their business activity in Kentucky. Notably, Taxpayers made a voluntary election to record 100% of the gain in the year of sale, rather than to record the gain over a period of time as "installment" sales. Taxpayers did so presumably to receive certain tax benefits. However,

> While a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequence of his choice, whether contemplated or not and may not enjoy the benefit of some other route he may have chosen to follow but did not.

Comm'r v. Nat'l Alfalfa Dehydrating, 417 U.S. 134, 148-149 (1974).

Because the taxpayer did not remit in full the amount of tax determined to be due under the provisions of KRS 141.040 and KRS 136.070 for each period for which tax was assessed, late payment penalties and failure to file estimated tax penalties were applied on the 2003 assessments in accordance with KRS 131.180(2)(3).

After reviewing the available information provided by the taxpayers and the applicable statutes, the position of the Department that the corporation income and license tax assessments issued against the Corporations for the CYE December 31, 2003 and CYE December 31, 2004 returns are valid liabilities due the Commonwealth of Kentucky.

This letter 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

Jason Snyder
Executive Director
Office of Legal Services for Revenue

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

cc: [redacted] PLLC
[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]