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Commissioner

In the matter of:

[redacted], LLC

Contact: [redacted], Executive Vice President
[redacted] Inc.
[redacted]

FINAL RULING NO. 2009-32
October 2, 2009

Assessment of Corporation Income Tax
Tax Years 2005 and 2006

FINAL RULING

The Kentucky Department of Revenue (the "Department") has issued corporation income tax assessments against [redacted], LLC (the "Taxpayer") for the taxable years 2005 and 2006. The following table provides a breakdown of the amount of tax due, all assessed fees and penalties, as well as accrued interest as of the date of this final ruling.

Tax Year	Tax	Interest	Penalty	Total
2005	[redacted]	[redacted]	[redacted]	[redacted]
2006	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]	[redacted]	[redacted]	[redacted]

The Taxpayer is a limited liability company that formed as a partnership and files Form 1065 for federal income tax purposes ("LLC"). In 2005, Kentucky expanded the corporation income tax for the tax years beginning on or after January 1, 2005 to include limited liability companies; therefore, for the tax years ended December 31, 2005 and December 31, 2006 the Taxpayer was deemed a corporation pursuant to KRS 141.010 (24) and filed Kentucky Partnership Income Tax Return, Form 765 for the taxable years 2005 and 2006.

At issue is the Department's disallowance of the Kentucky Net Operating Loss ("KNOL") deduction claimed by the Taxpayer for the taxable years 2005 and 2006.

For Kentucky, the Taxpayer is a pass-through entity for tax years beginning before January 1, 2005, and after December 31, 2006, pursuant to KRS 141.206(1) and KRS 141.010(26).

KRS 141.206(1) states:

(1) As used in this section unless the context requires otherwise:

(a) For taxable years beginning after December 31, 2004, and before January 1, 2007, "pass-through entity" means a general partnership not subject to the tax imposed by KRS 141.040, including any publicly traded partnership as defined by Section 7704(b) of the Internal Revenue Code that is treated as a partnership for federal tax purposes under Section 7704(c) of the Internal Revenue Code and its publicly traded partnership affiliates. "Publicly traded partnership affiliates" shall include any limited liability company or limited partnership for which at least eighty percent (80%) of the limited liability company member interests or limited partner interests are owned directly or indirectly by the publicly traded partnership; and

(b) For all other taxable years, "pass-through entity" means pass-through entity as defined in KRS 141.010.

KRS 141.010(26) states:

"Pass-through entity" means any partnership, S corporation, limited liability company, limited liability partnership, limited partnership, or similar entity recognized by the laws of this state that is not taxed for federal purposes at the entity level, but instead passes to each partner, member, shareholder, or owner their proportionate share of income, deductions, gains, losses, credits, and any other similar attributes;"

For the tax years 2002 through 2004 the Taxpayer properly filed a Partnership Income Return for Kentucky, and the corporate partners filed Kentucky Corporation Income and License Tax Returns, Form 720. The Taxpayer incurred losses in 2002 and 2003 which were properly passed through to its two corporate partners pursuant to KRS 141.206 (3).

KRS 141.206 (3) states:

> "Pass-through entities shall determine net income in the same manner as in the case of an individual under KRS 141.010(9) to (11) and the adjustment required under Sections 703(a) and 1363(b) of the Internal Revenue Code. Computation of net income under this section and the computation of the partner's, member's, or shareholder's distributive share shall be computed as nearly as practicable identical with those required for federal income tax purposes except to the extent required by differences between this chapter and the federal income tax law and regulations."

The 2002 & 2003 KNOLs were passed through to the corporate partners and partially utilized for the 2004 tax year. Therefore, the KNOLs belonged to the corporate partners, not the Taxpayer. Because the KNOLs belonged to the corporate partners, the Taxpayer had no KNOLs to carryforward for the 2005 and 2006 tax years pursuant to KRS 141.011(4).

KRS 141.011 (4) states:

> "For taxable years beginning on or after January 1, 2005, and before December 31, 2006, the net operating loss carryforward deduction of a corporation shall be reduced by the amount of distributive share income, loss, and deduction distributed to an individual or general partnership as defined in KRS 141.206."

The Taxpayer protested the disallowance of the KNOL deductions and the related assessments for the 2005 and 2006 tax years. The Taxpayer argues since, the two corporate partners were not required, based on the facts and circumstances in existence in 2005 and 2006 (namely, that they only did business in Kentucky through the Taxpayer) to file a Kentucky Corporation Income Tax Return, Form 720; therefore, the Taxpayer should be able to utilize the remaining KNOL carryforward belonging to the corporate partners that the Taxpayer generated in 2002 and 2003.

In support of this contention, the Taxpayer argues that the Department should look to the Internal Revenue Services' Laws and Regulations for guidance on the KNOL issue and have relied on the court case *School Street Associates Limited Partnership et al. and Sovran Bank/D.C National v District of Columbia ("Sovran")*, 764 A,.2d 798 (D.C. Ct. of App. 2001).

However, other than the fact that both *Sovran* and this present dispute involve partnerships and NOLs, there is nothing in *Sovran* which is applicable to the present dispute. The NOL statutes are markedly different, as are the taxing statutes. The main issue in *Sovran* was whether the fact that the partnership had no federal NOL meant that the partnership could not have any state NOL, either. Kentucky's NOL statute is not tied to the federal NOL, so that analysis is completely inapplicable. The Taxpayer in this case had no KNOL as of 12/31/04, and generated no KNOL in either 2005 or 2006.

Moreover, 103 KAR 16:250 also supports the Department's position. This regulation explains how to treat a KNOL that existed as of 12/31/04 in light of the legislative changes made in 2005. The Taxpayer had $[redacted] KNOL as of 12/31/04, because the KNOL belonged to its corporate partners. An LLC has no KNOL carry-forwards from periods prior to 12/31/04 because the LLC had no KNOL in past periods. However, it should be noted that, if the Taxpayer had incurred a loss in 2005, the KNOL generated for that year would have belonged to the Taxpayer, not the corporate partners, and could have been carried forward and applied against a gain in 2006, for example. Such a result is consistent with the result advocated in *Souran*.

Finally, the Taxpayer also argues that the Department's statutory interpretation fails to recognize that the only reason Taxpayer is being denied the KNOL carryforward is the change in the taxation of LLCs; and that the Legislative changes were intended to create uniformity in how C corporations and LLCs were taxed. The Taxpayers assert that the intent to treat the LLCs the same as C corporations dictates that LLCs retain NOL carryforwards, consistent with the general rule for C corporations.

Taxpayer is mistaken on this point as well. If the Taxpayer had converted from an LLC to a C corporation prior to 2005, it would not have been permitted to utilize the KNOL generated in 2002 and 2003 – those NOLs would remain with the corporate partners. The Taxpayer is being treated exactly the same as a C corporation that had no KNOL as of 12/31/2004. Similarly, as noted above, to the extent an LLC generated a loss in either 2005 or 2006, it would be entitled to the KNOL, just like a C corporation.

Simply put, what Taxpayer is asking for is the right to take away the KNOLs, to the extent there was a balance as of 12/31/2004, from its corporate partners. Taxpayer does not dispute that prior to 2005, the KNOLs belonged to its corporate partners. KNOLs can be carried forward for 20 years. Under Taxpayer's interpretation, the corporate partners would lose the ability to use those KNOLs in the future (through 2022 and 2023). The fact that the corporate partners did not use the KNOL in 2005 or 2006 does not necessarily mean that the opportunity will not arise between now and then. Moreover, according to Taxpayer, the corporate partners did use part of the KNOL in 2004.

What the Taxpayer requests would affect <u>all</u> LLCs/pass-through entities, not just Taxpayer. So, under Taxpayer's theory, all KNOL balances that existed as of 12/31/2004 would be taken away from the partners and brought back up to the LLC/pass-through entity level for the 2005 and 2006 tax years. To the extent the partners utilized part of the balance that existed on 12/31/2004 in the 2005 and 2006 tax years, those would have to be disallowed, and an assessment the most likely result of the disallowance. As discussed above, this legally cannot be the right result.

After reviewing the available information, and the applicable statutes, it is the position of the Department that the outstanding corporation income tax assessments issued against the Taxpayer for the 2005 and 2006 tax years are valid liabilities due the Commonwealth of Kentucky.

This letter is the final ruling of the Department.

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

E. Jeffrey Mosley / by LMF

E. Jeffrey Mosley
Interim Executive Director
Office of Legal Services

cc: [redacted] PSC
[redacted]

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

[redacted]

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