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Secretary

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In the matter of:

██████████ Company

Contact: ██████████ and Company

██████████
██████████

Final Ruling No. 2011-44
May 20, 2011

FINAL RULING

The Kentucky Department of Revenue (the "Department") issued corporation income tax assessments against ██████████ and Company ("██████████") for the fiscal years ended September 30, 2006, September 30, 2007 and September 30, 2008 as a result of the reclassification of a net capital gain from nonbusiness income to business income which was made in a prior audit. This prior reclassification affected the amount of Kentucky net operating loss available to be applied to the fiscal years ended September 30, 2006, September 30, 2007 and September 30, 2008. The following table provides a breakdown of the amount of tax due as well as accrued interest as of the date of this letter.

Period	Tax	Interest	Total
09/30/2006	██████████	██████████	██████████
09/30/2007	██████████	██████████	██████████
09/30/2008	██████████	██████████	██████████
Total	██████████	██████████	\$ ██████████

As an initial matter, the issue of whether the net gain attributable to the sale of ██████████'s interest in ██████████, Inc. ("██████████") stock and ██████████, Inc. ("██████████") stock was business income or nonbusiness income was addressed in a prior audit. That prior audit involved the fiscal years ending September 30, 1999, September 30, 2000 and September 30, 2001. The transactions involving ██████████ and ██████████ were reclassified from nonbusiness income to business income. This resulted in a \$ ██████████ adjustment, which comprises the \$ ██████████ capital gain from the sale of ██████████ stock, and the \$ ██████████ capital gain from the sale of ██████████ stock. This adjustment reduced the amount of Kentucky net operating losses ("KNOL") available for future years. This adjustment was identified in the notices sent to ██████████ on ██████████, 2003. There was also an adjustment to license tax for these tax years which resulted



in a license tax assessment. ██████████ paid the license tax assessment on ██████████, 2003. No protest was made to the adjustments made in the notices. Pursuant to KRS 131.110, for a protest to be timely, it had to be made on or before ██████████, 2003. Additionally, the statute of limitations has run on the fiscal year ended September 30, 2000. KRS 134.580. As a result, it is too late for ██████████ to raise this issue now.

Subsequent to the 1999-2001 audit, ██████████ filed several amended returns reflecting adjustments made by the Internal Revenue Service, which also affected the amount of KNOL. However, for fiscal years ended September 30, 2006, September 30, 2007 and September 30, 2008, the KNOL applied by ██████████ to those returns reflected only the adjustments made by the Internal Revenue Service, but not the 1999-2001 audit.

██████████ raised the issue regarding the adjustment to the KNOL resulting from the reclassification of the net gain from the sale of ██████████ stock and ██████████ stock for the first time on ██████████, 2009, more than six years too late. While the auditor acknowledged the protest, he had not gone back and looked at the 1999-2001 audit to see how that audit handled the business/nonbusiness reclassification issue. The deadline to protest an adjustment to an audit is not waivable. Koehler v. Commonwealth, 432 S.W.2d 397, 398 (Ky. 1968) (failure to object to classification of income through exclusive remedy resulted in classification becoming final).

While ██████████'s failure to protest this issue back in 2003 is dispositive of this issue; even if, assuming for the sake of argument that ██████████ had timely protested this issue, the adjustment from nonbusiness income to business income was valid and proper.

██████████ is a multinational ██████████ corporation headquartered and commercially domiciled in ██████████, ██████████. ██████████ is engaged directly and indirectly, through its wholly owned domestic and foreign subsidiaries, in the manufacture and sale of a broad range of medical, diagnostic and safety products used by the healthcare professionals, medical research institutions and the general public.

On ██████████, 1997, ██████████ purchased ██████████ preferred shares of ██████████ for \$ ██████████. This purchase represented a ██████████% ownership interest in ██████████. On ██████████, 1998, ██████████ surrendered its preferred stock in exchange for ██████████ shares of ██████████ common stock. On ██████████, 1998, ██████████ purchased an additional \$ ██████████ (██████████ shares) of ██████████ common stock, which increased ██████████'s ownership interest to ██████████%.

██████████ also entered into a collaborative research and development agreement with ██████████. Pursuant to this agreement, ██████████ formed a partnership with ██████████ in ██████████ 1997 to develop and commercialize test systems to diagnose ██████████. As part of this partnership, ██████████ made contributions of \$ ██████████ in the fiscal year ending September 30, 1998 and \$ ██████████ in the fiscal year ending September 30, 1999.

Beginning February 2000 through September 2000 ██████████ sold all of its ██████████ shares for a long-term capital gain of \$ ██████████.

On ██████████, 1999, ██████████ purchased ██████████ preferred shares of ██████████ for \$ ██████████. This purchase represented a ██████████% ownership interest in ██████████. In ██████████ 2000, ██████████ received ██████████ shares of ██████████ in exchange for its ██████████ shares of ██████████ in a tax-free reorganization under IRC 368(a).

██████████ also entered into a ██████████ year research collaboration and license agreement with ██████████. Pursuant to this agreement, ██████████ paid ██████████ \$ ██████████ in research funding in the fiscal year ending September 30, 1999, and \$ ██████████ in research funding in the fiscal year ending September 30, 2000.

On ██████████, 2000, ██████████ sold all of its ██████████ shares for a long-term capital gain of \$ ██████████.

In addition, as part of the ownership of ██████████ stock, on ██████████, 1997 ██████████ and ██████████ entered a Collaboration and Licensing Agreement (“██████████ Agreement”) to perform research and development (“Research Program”) to produce products which would utilize ██████████ ██████████ ██████████ (“██████████”). ██████████ has developed certain technology related to electronically addressable ██████████ and ██████████ has developed certain technology related to methods for creating multiple copies of an ██████████ ██████████ known as ██████████ ██████████.

Subject to the terms of the ██████████ Agreement, ██████████ agreed to make certain cash contributions to ██████████ and other resources which were to be dedicated to the Research Program. The cash payments described above were to be used exclusively for activities under the Research Program. ██████████ received ██████████ stock in exchange for these contributions.

Per the ██████████ Agreement, any invention resulting from the joint program was to be jointly owned by ██████████ and ██████████.

For purposes of determining ownership of intellectual property and patent rights, if one of the party's employees was performing services on site at the facilities of the other party, such employees were to be deemed to be the employees of the company at which site they are performing services.

It is the Department's position that the investment in ██████████ was used in the Research Program created income from intellectually property rights which the Department would deem to be business in nature.

Similarly, as part of the ownership of ██████████ stock, on ██████████, 1999 ██████████ and ██████████ entered a Collaboration and Licensing Agreement (the “██████████ Agreement”) with an interest in collaborating in certain areas of ██████████ research to discover novel diagnostic and ██████████ products (“Program”). As part of the ██████████ Agreement, each party was to designate three (3) company representatives to be part of a joint steering committee whose duties were to oversee the Program.

The goals of the Program were to develop more efficient ██████████ tools, ██████████ ██████████, and ██████████ to direct the appropriate regime of ██████████. The goal of the ██████████ was to identify ██████████ in the absence of ██████████.

The specific program milestones were to discover ██████████, validate the ██████████ utility of the ██████████, submit for regulatory approval and commercialize as ██████████ and ██████████ tests. ██████████ was to discover the ██████████ and validate the ██████████ efficacy. The development of the ██████████ in a ██████████ format could be done by either ██████████ or ██████████, and was dependent upon the particular product. ██████████ was responsible for developing the ██████████ in a commercial format, conducting ██████████ trials in support of regulatory approval and commercializing the ██████████.

Subject to the terms of the ██████████ Agreement, ██████████ agreed to make certain cash contributions to ██████████ and other resources, all of which were to be dedicated to the Program. The cash payments described above were to be used exclusively for activities under the Program. ██████████ received ██████████ stock in exchange for these contributions.

Per the ██████████ Agreement, any invention resulting from the joint program shall be jointly owned by ██████████ and ██████████. It is the Department’s position that the investment in ██████████ was used in the Program which could have created income from intellectually property rights which the Department would deem to be business in nature.

Kentucky imposes an income tax on corporations doing business in this State. KRS 141.040 (1). Business income of a multistate corporation doing business in Kentucky is apportionable to this State. KRS 141.010(14)(b); 141.120(2),(8). Under the United States Constitution, a State may tax an apportioned sum of a corporation’s entire business if the corporation’s intrastate and extrastate activities form part of a single unitary business. Meadwestvaco Corp. v. Illinois Dep’t of Rev., 553 U.S. 16, 25 (2008).

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

“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.

“Nonbusiness income’ means all income other than business income.” KRS 141.120(1)(e).

Kentucky follows the approach of other jurisdictions that have adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”) by applying two alternative and distinct approaches for determining whether corporate income is classified as apportionable business income. 103 KAR 16:060. If either the “transactional test” or the “functional test” is satisfied, the income is business income. Id. at Sections 3 and 4.

Under the functional test, business income includes income from tangible and intangible property “if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” Id. at Sec. 4. Income from intangible property is business income if the intangible property serves an operational as opposed to solely an investment function. Id. at Sec. 4 (3).

The intangible property serves an operational function if it is or was held in furtherance of the taxpayer’s trade or business as evidenced by the objective characteristics of the intangible property’s use or acquisition in relation to the taxpayer and the taxpayer’s activities. The functional test shall not be satisfied if the holding of the property is limited to solely an investment function.

* * *

Income arising from an intangible interest as, for example, corporate stock or other intangible interest in a business or a group of assets, shall be business income if the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer’s trade or business operations.

Id. at Sec. 4 (3) and (6)(a).

The activities under the ██████████ Agreement and the ██████████ Agreement which were part of the stock ownership, clearly establish that the activities with ██████████ and ██████████ were of an operational, rather than an investment function.

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 40601-3714, 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 3 of 802 KAR 1:010:

1. An individual may represent himself in any proceedings before the Board where his individual tax liability is at issue or he may obtain an attorney to represent him in those proceedings;
2. An individual who is not an attorney may not represent any other individual or legal entity in any proceedings before the Board;
3. Any party appealing a final ruling to the Board other than an individual, such as a corporation, limited liability company, partnership, joint venture, estate or other legal entity, shall be represented by an attorney in all proceedings before the Board, including the filing of the petition of appeal; and
4. An attorney who is not licensed to practice in Kentucky may practice before the Board only 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 for Revenue