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LORI HUDSON FLANERY
Secretary

THOMAS B. MILLER
Commissioner

In the matter of:

██████████ Corporation

Contact: ██████████ Corporation

Attn: ██████████
██████████

FINAL RULING NO. 2012-54
October 19, 2012

Adjustment to Kentucky Taxable Income
For the Fiscal Periods Ended October 31, 2006,
October 31, 2007 and October 31, 2008

FINAL RULING

The Kentucky Department of Revenue (the "Department") has made adjustments to Kentucky taxable income for the above-referenced taxable periods to reflect related expense deductions to nontaxable income that were not added back on the Kentucky income tax returns as originally filed.

For the taxable periods ended October 31, 2006 and October 31, 2007, the related expense adjustment to correct taxable income resulted in a decrease in the net losses for the two periods. For the taxable period ended October 31, 2008, the related expense adjustment to corrected taxable income resulted in an increase in net income for the period. The resulting increase in net income was absorbed by the net operating loss available to be used in the period. The decrease in the net losses for the periods ended October 31, 2006 and October 31, 2007 was \$██████████ and \$██████████ respectively while the increase the net income for taxable period ended October 31, 2008 was \$██████████.

At issue in this dispute is whether the taxpayer properly related expenses to the nontaxable income in accordance with KRS 141.010(13)(d)(4). KRS 141.010(13)(d)(4) provides:

(13) "Net income," in the case of corporations, means "gross income" as defined in subsection (12) of this section minus:

(d) All the deductions from gross income allowed corporations by Chapter 1 of the Internal Revenue Code and as modified by KRS 141.0101, except:

4. 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;

The Department opened a review of the returns in question and determined that the taxpayer had failed to relate expenses and add them back per the foregoing statute. The Department, with the information at hand, then determined the best method under the provisions of Regulation 103 KAR 16:060 (the "Regulation") in which to relate the expenses. The Department utilized the method prescribed in Section 7(c) of the Regulation, 1.75 % of the average cost of the assets producing nontaxable income.

It is the taxpayer's position that it related expenses on the original return in accordance with KRS 141.010(13)(d) and in accordance with IRC § 482. IRC § 482 was established to allocate income and deductions among taxpayer in different tax jurisdictions. IRC § 482 states in its entirety:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

KRS 141.010(13)(d) does not reference IRC § 482, nor does IRC § 482 address expenses related to nontaxable income. IRC § 482 applies to transfer pricing and can include items that are business income and expenses at the State level. Similarly, nonbusiness or nontaxable income may be derived from an organization that is not "owned or controlled directly or indirectly by the same interest".

It is the Department's position that transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes. OECD Transfer Pricing Guidelines state, "Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions." None of these pertains to related expenses.

The Department also maintains that transfer pricing does not apply to portfolio income. The only intangible income that would be affected by the transfer pricing rules are those defined by IRC§ 936(h)(3)(B). IRC§ 936(h)(3)(B) provides:

Intangible property. The term "intangible property" means any—
(i) patent, invention, formula, process, design, pattern, or know-how;
(ii) copyright, literary, musical, or artistic composition;
(iii) trademark, trade name, or brand name;
(iv) franchise, license, or contract;
(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
(vi) any similar item, which has substantial value independent of the services of any individual.

None of these items include portfolio income.

The taxpayer provided documents pertaining to how it arrived at expenses it claims were related to the nontaxable income reported on the return and added back in accordance with the statute. However, this information pertained to OECD transfer pricing and did not have any relationship to either related expenses or nontaxable income.

The taxpayer has provided no additional information in support of its claim nor has it suggested another method in the Regulation. It is therefore the Department's position that the related expense adjustments for all periods are valid.

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
Interim Executive Director
Office of Legal Services for Revenue

CERTIFIED MAIL
RETURN RECEIPT REQUESTED



