March 2006

BDO Seidman, LLP
Accountants and Consultants

State Tax Alert

Kentucky Corporate Partner Refund Opportunity and Emergency Tax Regulations Highlights

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A. Recent Kentucky Board of Tax Appeals Decision Presents Corporate Tax Refund Opportunity to Corporate Partners Without Physical Presence in Kentucky who Paid Corporate Income Tax:

The Kentucky Board of Tax Appeals ("BTA") recently decided in Asworth Corp. et. al. v. Revenue Cabinet, File Nos. K00-R-31, K02-R-30, K02-R-31 and K02-R-32 (January 27, 2005) that a foreign corporate partner whose only connection to the state of Kentucky was its ownership interest in a partnership that conducted business in Kentucky was insufficient to subject the corporate partner to Kentucky's corporate income tax. The parties stipulated that Asworth was a foreign corporation and that its only connection with the state of Kentucky was its ownership interest in a partnership conducting business in Kentucky.

Under Kentucky law for the periods at issue, the corporate income tax imposition statute provided in relevant part:

> "… every foreign corporation owning or leasing property located in this state or having one (1) or more individuals receiving compensation as defined in KRS 141.120(8)(b) in this state… shall pay for each taxable year a tax to be computed by the taxpayer on taxable net income…"

KRS §141.040 (2004). Asworth argued that the above referenced statute excluded Asworth from its purview. The Kentucky Revenue Cabinet (the "Cabinet") agreed with Asworth on this point. The Cabinet argued however, that Asworth's receipt of a "partnership distributive share" from an entity doing business in Kentucky was enough to satisfy the "substantial nexus" constitutional standard. Thus, the Cabinet reasoned that Asworth was subject to Kentucky corporate income tax.

The BTA did not address several other arguments presented by Asworth or the Cabinet's constitutional nexus argument. The BTA considered its function to dispose of the case based on the narrowest issue in controversy. As a result, the

BTA decided the case based on a literal reading of the statute and held that Asworth did not meet the statute's definition and as such was exempt from Kentucky's corporate income tax. It is anticipated that the Cabinet will appeal the BTA's ruling.

Based on the decision in Asworth, a corporation that does not have physical presence in Kentucky but paid Kentucky corporate income tax based on its receipt of partnership income from a partnership doing business in Kentucky should consider filing refund claims for all open years. Calendar year taxpayers should be able to amend and claim a refund for tax years 2001, 2002, 2003 and 2004 unless these tax years have otherwise been closed.

The refund opportunity is limited to tax years beginning on or before December 31, 2004. This is because new legislation enacted under H.B. 272 (effective January 1, 2005) subjects limited partnerships and other similar limited liability entities (previously exempt from Kentucky corporate income tax) to Kentucky corporate income tax. Likewise, entities that maintain an interest in a general partnership doing business in Kentucky will also be subject to the Kentucky corporate income tax. Kentucky corporate income tax returns are due on or before the fifteenth day of the fourth month following the end of the fiscal or calendar year (excluding six month extension). Kentucky's statute of limitations period for refunds is generally four years measured from the due date of the return including extensions.

Similarly, it has been long standing principle that only formally incorporated entities with independent license tax nexus are subject to the license tax. Corporations doing business in Kentucky solely as a partner, member or shareholder are not subject to the Kentucky license tax. Thus, similar refund opportunities may be presented on similar grounds to the extent a corporation pays license tax and its only connection to Kentucky is its ownership interest in a separate legal entity conducting business in Kentucky.

B. Kentucky Promulgates Emergency Tax Regulations:

As many practitioners are aware, on March 18, 2005 Kentucky Governor Ernie Fletcher signed H.B. 272 which, among other things, eliminated the Kentucky Corporate License Tax and defines most pass-through entities as C corporations, subjecting them to the Kentucky Corporate Income Tax. The effective date for many of the changes listed in H.B. 272 bill was for taxable years beginning on or after January 1, 2005. In addition to the passage of this tax bill, the governor signed into law other bills, a total of 18 bills were signed, with tax provisions that could have a substantial impact on businesses within Kentucky.

In response to the new tax changes, the Kentucky Finance and Administration Cabinet's Department of Revenue ("KY DOR") promulgated several emergency administrative regulations, which became effective February 1, 2006. The regulations purport to apply retroactively to taxable years beginning on or after January 1, 2005.

Under Kentucky statutory law, emergency administrative regulations are effective and are considered adopted upon filing. Generally, emergency administrative regulations remain effective until an ordinary administrative regulation is adopted. While emergency administrative regulations that are to be replaced by ordinary regulations require no public hearing, finalization of ordinary regulations require an opportunity for public hearing and comment. The Kentucky Division of Legislative Services will accept all written notices to be heard at the public hearings if received at least five working days prior to the hearing date. Written comments will be accepted if received by March 31, 2006 at the following address:

Attn: Leslie Saunders
Division of Legislative Services
Finance and Administration Cabinet
Room 195B
Capitol Annex
Frankfort, KY 40601

Kentucky has established the following dates for public hearings on each of the five emergency regulations, for which an identical ordinary regulation is subject to review:

Emergency Regulation #	Public Hearing Date	Written Comments Deadline
103 KAR 1:080E – Withdrawal of Policies & Circulars	3/24/06	3/31/06
103 KAR 16:240E – Nexus	3/24/06	3/31/06
103 KAR 18:070E – Supplemental Wages & Nonresident Withholding	3/25/06	3/31/06
103 KAR 16:060E – Income Classification	3/22/06	3/31/06
103 KAR 15:020E Election to Pay Share of Tax on Behalf of Corporation	3/31/06	3/31/06

C. Overview of Regulatory Changes:

The KY DOR promulgated five administrative regulations, which each are effective for tax years beginning on or after January 1, 2005. These regulations are summarized below.

1. ***103 KAR 1:080E, Policies and Circulars (new regulation),*** withdraws approximately 246 policies and circulars. The policies and circulars provided guidance for a variety of taxes including income, sales and use, property and severance tax. In addition, the policies and circulars provided administrative tax guidance and guidance regarding business incentives. The legitimacy of this regulation is questionable because it withdraws, and does not replace, the guidance once provided by these policies and circulars.

2. ***103 KAR 16:240E, Nexus Standard for Corporations and General Partnerships (new regulation),*** establishes standards applicable to corporations and general partnerships regarding what constitutes nexus in Kentucky. The new regulation significantly expanded the definition of "doing business" in Kentucky up to the limits imposed by the U.S. Constitution and Federal Interstate

Income Tax Law (P.L. 86-272).[1] The new regulation accounts for prior nexus creating activities and sets out new nexus creating activities, which include:

> Performing services in Kentucky indirectly by directing the activity performed by a third party;
>
> Maintaining an interest in a general partnership doing business in the state; and
>
> Receiving income from intangible personal property if the intangible personal property has acquired a Kentucky "business situs".

3. ***103 KAR 18:070E, Supplemental Wages and Other Payments Subject to Withholding (amended regulation),*** removes the non-resident withholding requirement on the net distributive share of income from a pass-through entity. The withholding requirement is no longer warranted since H.B. 272 subjects pass-through entities to the Kentucky corporate income tax. Since the tax is imposed at the entity level, a nonresident individual owner's state of residency may not allow the individual a credit on his/her personal income tax return for taxes paid to Kentucky by the pass-through entity. However, this potential inequity may be cured by Kentucky emergency regulation 103 KAR 15:020E. (See #4 below)

4. ***103 KAR 15:020E, Electing to Pay Corporation's Share of Tax (new regulation),*** provides a method for pass-through individual owners to elect to pay its proportionate share of the Kentucky Corporate Income Tax imposed on the pass-through entity. The pass-through individual owners effectuate the election by filing with the pass-through entity a signed notarized statement of intent to pay the pass-through individual owner's proportionate share of tax due. The election statement must include amongst other items, an acknowledgement of liability for tax and an acknowledgement of the state's personal jurisdiction. The election must be filed prior to the due date of the entity's annual return including extensions.[2] Once properly filed, the pass-through entity acts like a designated agent on behalf of its owners (e.g., collects and remits tax, receives overpayment refunds, etc.).

   The election shall be void if the payment of tax is not remitted with the pass-through entity's timely filed annual return. The pass-through entity shall remain liable for the entire tax liability. Notwithstanding this fact, the election may allow the pass-through individual owners the opportunity to deduct taxes paid to Kentucky on his/her personal income tax return filed in his state of residence.

5. ***103 KAR 16:060E, Income Classification; Business and Non-Business (amended),*** establishes criteria for classification of corporate income into business and nonbusiness components and clarifies that Kentucky follows the standard UDIPTA transactional and functional tests. While the amendment does not change the definitions of "business income" or "nonbusiness in-

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[1] Prior to 2005, Kentucky's nexus standard for imposing its income tax included only (1) having a principal place of business in Kentucky, (2) having property in Kentucky or (3) having individuals in Kentucky receiving compensation from the corporation. See KRS §141.010(25) (2004).

[2] The regulation includes a sample example of a pass-through owner election to pay its share of tax.

come", it provides that the KY DOR must apply both the transactional and functional tests in determining whether income is or is not "business income". The amendment deletes certain examples of what constituted business or non-business activities. It also provides new examples of transactions or activities that may meet either the transactional or functional tests, including, proceeds from the liquidation or winding-up of a business and income from the licensing of intangibles (e.g., patents, copyrights, etc).

Moreover, the amendment excludes transactions relating solely to investment activities and property that has been converted to nonbusiness use. The regulation generally presumes that property which is idle for a period of five years or more has converted from a business to a nonbusiness characterization. Expenses directly or indirectly related to nonbusiness income must be excluded from deductions taken on the Kentucky corporate income tax return. To the extent actual expenses cannot be determined, KY DOR provides a five prong test taxpayers must use to determine the appropriate deduction.

D. Overview of Tax Changes in 2005:

The 2005 tax changes were some of the most significant Kentucky's taxing scheme has undergone. Some of the areas of tax that changed, and their respective bill numbers, are as follows:

Administrative
Electronic Records – H.B. 497
Fraud – H.B. 497
Utility Gross Receipts License Tax – H.B. 497
Refund Claims – H.B. 498
Department of Revenue Reorganization – S.B. 49

Alcoholic Beverage Tax – H.B. 272

Corporation Income Tax
Corporation Income Tax Base Expansion – H.B. 272
Rate Reduction – H.B. 272
Reference to Internal Revenue Code – H.B. 272
Alternative Minimum Tax – H.B. 272
Mandatory Nexus Consolidated Returns – H.B. 272
Related Party Expense Disallowance – H.B. 272
Nexus Standard – H.B. 272
Net Operating Losses – H.B. 272
Apportionment – H.B. 272
Phase II Tobacco Payments – H.B. 272
Conversion – S.B. 142

Economic Development Incentives and Credits
Kentucky Investment Fund Act Credits – H.B. 267
Clean Coal Incentive Credit – H.B. 272
Brownfields Credit – H.B. 272
Environmental Stewardship Credit – H.B. 272
Biodiesel Credit – H.B. 272
Recycling Tax Credits – H.B. 272
Historic Preservation Credit
Enterprise Initiative Act – H.B. 272

Healthcare Provider Tax
Nursing Homes – H.B. 439
Classifications – H.B. 461

Individual Income Tax
Reference to Internal Revenue Code – H.B. 272
Family Size Tax Credit – H.B. 272
Rate Reduction – H.B. 272
Net Operating Losses – H.B. 272
Phase II Tobacco Payments – H.B. 272
Pensions – H.B. 272
Education Tuition Tax Credit – H.B. 272
Health Savings Accounts – H.B. 272
Refund Designation – H.B. 7

Motor Fuels Tax
Refunds – H.B. 494
Underground Storage Tank Fees – H.B. 494
Bulk Sales – H.B. 494
Payments – H.B. 494
Financial Instruments – H.B. 494
Average Wholesale Price of Gas – H.B. 267

Motor Vehicle Usage Tax
Collection of Motor Vehicle Usage Tax at Titling – H.B. 267
Charter Buses – H.B. 267

Pari-mutuel Tax – H.B. 350; H.B. 497

Property Tax

Property Owned by Another State – H.B. 267
Local School Districts – H.B. 267
Intangible Property Tax Repealed – H.B. 272
State Real Property Tax Rate – H.B. 272
School Funding – H.B. 272
Biotechnology Products – H.B. 308
Barge Lines – H.B. 350
School Tax Recall – S.B. 13
Airport Authorities – S.B. 111
Brownfields Incentives – H.B. 272

Sales and Use Tax

Donated Goods – H.B. 267
Repair and Replacement Parts for Charter Buses – H.B. 267
Vendor Compensation – H.B. 267
Commercial Printers or Mailers – H.B. 267
Natural Gas – H.B. 267
Water Withdrawal Fees – H.B. 267
Breeder Incentives – H.B. 272
Nexus – H.B. 272
Sales Tax Exemption Study – H.B. 272
Streamlined Sales Tax – H.B. 495
County Fair Admissions – H.B. 497
Telephones/Pay Phones – H.B. 272

Telecommunications Services

Excise Tax – H.B. 272
Gross Revenues Tax – H.B. 272

Tobacco Taxes

Cigarettes – H.B. 272
Cigarette Tax Levy – H.B. 267
Inventory Floor Tax – H.B. 272
Other Tobacco Products – H.B. 272
Cigarette Compensation – H.B. 272
Tobacco Research Trust Fund – H.B. 497

Tourism

Transient Room Tax – H.B. 272
State or National Parks – H.B. 497
Boxing and Wrestling – H.B. 272

Utility Gross Receipts License Tax – H.B. 272