103 KAR 16:060. Income classification; apportionable and non-apportionable.

RELATES TO: KRS 141.010, 141.120
STATUTORY AUTHORITY: KRS 131.130
NECESSITY, FUNCTION, AND CONFORMITY: KRS 131.130(1) authorizes the department to promulgate administrative regulations necessary to administer and enforce Kentucky's tax laws. KRS 141.120 contains provisions for assigning to Kentucky the apportionable income and non-apportionable income of multistate corporations. This administrative regulation establishes criteria for classification of corporate income into its apportionable and non-apportionable components, allocates expenses for non-apportionable income, and clarifies that Kentucky follows both the transactional and functional tests. The examples used throughout this administrative regulation are illustrative only and are limited to the facts contained within.

Section 1. Definitions. (1) "Acquisition" means the act of obtaining an interest in property.
(2) "Allocation" means non-apportionable income specifically assigned or allocated to one or more specific jurisdictions.
(3) "Apportionable income" is defined by KRS 141.120(1)(a).
(4) "Apportionment" means apportionable income divided among jurisdictions by use of the apportionment factor provided in KRS 141.120.
(5) "Disposition" means the act or the power to relinquish or transfer an interest in or control over property to another, in whole or in part.
(6) "Management" means the oversight, direction, or control, directly or by delegation, of the property for the use or benefit of the trade or business.
(7) "Non-apportionable income" is defined in KRS 141.120(1)(d).
(8) "Trade or business" as used in the definition of apportionable income and in the application of that definition means the unitary business of the taxpayer, part of which is conducted within Kentucky.

Section 2. Determination of Apportionable Income. In determining whether income is apportionable income, the Department of Revenue shall apply both the transactional test and the functional test as established in Sections 3 and 4 of this administrative regulation. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, income derived from accounts receivable, operating income, non-operating income, etc., is of no aid in determining whether income is apportionable or non-apportionable income.

Section 3. Transactional Test. Apportionable income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business in accordance with this section. (1) If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within Kentucky, the resulting income of the transaction or activity is apportionable income for Kentucky. Income may be apportionable income even though the actual transaction or activity that gives rise to the income does not occur in Kentucky.
(2) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity is not required to frequently occur in the trade or business.
(a) Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test.
(b) It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are:
1. Customary in the kind of trade or business being conducted; or
2. Within the scope of what that kind of trade or business does.

(c) If a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer’s financial betterment rather than for the operations of the trade or business, those activities shall not satisfy the transactional test.

(d) The transactional test includes:
1. Income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business; and
2. Income from the sale of property used in the production of apportionable income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(3) The corporation shall classify income as apportionable or non-apportionable income on a consistent basis. If the corporation is not consistent, it shall disclose in its Kentucky return the nature and extent of the inconsistency.

Section 4. Functional Test. Apportionable income also includes income from tangible and intangible property, including any direct or indirect interest in, control over, or use in the property held directly, beneficially, by contract, or otherwise, that contributes to the production of apportionable income, if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer’s trade or business. (1) Under the functional test, apportionable income shall not be required to be derived from transactions or activities that are in the regular course of the taxpayer’s own particular trade or business.

(a) Except as provided in paragraph (b) of this subsection, it shall be sufficient if the property from which the income is derived is, or was a functional, operative component, or related to or used in the taxpayer’s trade or business operations, or otherwise materially contributed to the production of apportionable income of the trade or business, part of which trade or business is or was conducted within this state.

(b) Property that has been converted to an investment purpose through the passage of a sufficiently lengthy period of time (generally, five (5) years shall be sufficient) or that has been removed as an operational asset and is instead held by the taxpayer’s trade or business exclusively for investment purposes, shall be deemed to have lost its character as a business asset.

(c) Property that was related to a part of the trade or business shall not be considered converted to investment purposes merely because it is placed for sale.

1. Example: Taxpayer purchases a chain of 100 retail stores for the purpose of merging those store operations with its existing business. Five (5) of the retail stores are redundant under the taxpayer’s business plan and are sold six (6) months after acquisition. Even though the five (5) stores were never integrated into the taxpayer’s trade or business, the income is apportionable because the property’s acquisition was related to the taxpayer’s trade or business.

2. Example: Taxpayer is in the business of developing adhesives for industrial and construction uses. In the course of its business, it accidentally creates a weak but non-toxic adhesive and patents the formula, awaiting future applications. Another manufacturer uses the formula to create temporary body tattoos. Taxpayer wins a patent infringement suit against the other manufacturer. The entire damages award, including interest and punitive damages, constitutes apportionable income.

3. Example: Taxpayer is engaged in the oil refining business and maintains a cash reserve for buying and selling oil on the spot market as conditions warrant. The reserve is held in overnight "repurchase agreement" accounts of U.S. treasuries with a local bank. The interest on those amounts is apportionable income because the reserves are necessary for the taxpayer’s
business operations. Over time, the cash in the reserve account grows to the point that it exceeds any reasonably expected requirement for acquisition of oil or other short-term capital needs and is held pending subsequent business investment opportunities. The interest received on the excess amount is non-apportionable income.

4. Example: A manufacturer decides to sell one (1) of its redundant factories to a real estate developer and transfers the ownership of the factory to a special purpose subsidiary, SaleCo as the taxpayer, and immediately prior to its sale to the real estate developer. The parties elect to treat the sale as a disposition of assets under IRC 338(h)(10), resulting in the taxpayer recognizing a capital gain on the sale. The capital gain is apportionable income. Although the gain is apportionable, application of the standard apportionment formula in KRS 141.120 may not fairly reflect the taxpayer’s business presence in any state, necessitating a resort to equitable apportionment pursuant to KRS 141.120 (12)(a).

(2)(a) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in the full or partial liquidation or the winding-up of any portion of the trade or business, is apportionable income, if the property is or was related to the taxpayer’s trade or business operations, unless the property has been converted to investment purposes.

(b) Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business, constitutes apportionable income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

(3) Under the functional test, income from intangible property is apportionable income when the intangible property serves an operational function as opposed to solely an investment function. 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 and its 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 for a period of five (5) years or more.

(4)(a) If the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer’s trade or business, then income from that property is apportionable income, even though the actual transaction or activity involving that property that gives rise to the income does not occur in Kentucky.

1. Example: A manufacturer purchases raw materials to be incorporated into the product it offers for sale. The nature of the raw materials is such that the purchase price is subject to extreme price volatility. To protect itself from extreme price increases or decreases, the manufacturer enters into future contracts pursuant to which the manufacturer may either purchase a set amount of the raw materials for a fixed price, within a specified time period, or resell the future contracts. Any gain on the sale of the future contracts would be considered apportionable income, regardless of whether the contracts were either made or resold in Kentucky.

2. Example: A national retailer produces substantial revenue related to the operation of its trade or business. It invests a large portion of the revenue in fixed income securities which are divided into three (3) categories:
   a. Short-term securities held pending use of the funds in the taxpayer’s trade or business;
   b. Short-term securities held pending acquisition of other companies or favorable developments in the long-term money market; and
   c. Long-term securities held as an investment.

   (b) Interest income on the short-term securities held pending use of the funds in the taxpay-
er's trade or business pursuant to clause a. of subsection 4(a) 2. of this section is apportionable because the funds represent working capital necessary to the operations of the taxpayer's trade or business.

(c) Interest income derived from the other investment securities pursuant to clause b. and c. of subsection 4(a) 2. of this section is not apportionable as those securities were not held in furtherance of the taxpayer's trade or business.

(5)(a) An item of property shall be presumed to be related to the taxpayer's trade or business operations if the taxpayer:

1. Takes a deduction from income that is apportioned to Kentucky; or
2. Includes the original cost in the property factor, if applicable.

(b) No presumption arises from the absence of an action described in paragraph (a) of this subsection.

(6) Application of the functional test is generally unaffected by the form of the property (e.g., tangible or intangible property, real or personal property).

(a) Income arising from an intangible interest as, for example, corporate stock or other intangible interest in an entity or a group of assets, is apportionable income when the intangible itself or the property underlying or associated with the intangible is or was related to the operation of the taxpayer's trade or business.

(b) While apportionment of income derived from transactions involving intangible property may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, establishment of a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function.

Section 5. Examples of Apportionable and Non-apportionable Income. (1) Rents from real and tangible personal property. Rental income from real and tangible property is apportionable income if the property with respect to which the rental income was received is or was used in the taxpayer's trade or business.

(a) Example: The taxpayer operates a multistate car rental business. The income from car rentals is apportionable income.

(b) Example: The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is apportionable income.

(c) Example: The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five (5)-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two (2) floors are held for future use in the trade or business and are leased to tenants on a short-term basis in the meantime. The rental income is apportionable income.

(d) Example: The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not apportionable income of the grocery store trade or business. Therefore, the net rental income is non-apportionable income.

(e) Example: The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a twenty (20)-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining eighteen (18) floors are leased to others. The rental of the eighteen (18) floors is not done in furtherance
of, but rather is separate from, the operation of the taxpayer's trade or business. The net rental income is not apportionable income of the clothing store trade or business. Therefore, the net rental income is non-apportionable income.

(f) Example: The taxpayer constructed a plant for use in its multistate manufacturing business and twenty (20) years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold eighteen (18) months later. The rental income is apportionable income and the gain on the sale of the plant is apportionable income.

(2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes apportionable income if the property while owned by the taxpayer was related to the operation of the taxpayer's trade or business.

(a) Example: In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the trade or business. The gains or losses resulting from those sales constitute apportionable income.

(b) Example: The taxpayer constructed a plant for use in its multistate manufacturing business and twenty (20) years later sold the property at a gain while it was in operation by the taxpayer. The gain is apportionable income.

(c) Example: Same as paragraph (b) of this subsection, except that the plant was closed and put up for sale but was not in fact sold until a buyer was found eighteen (18) months later. The gain is apportionable income.

(d) Example: Same as paragraph (b) of this subsection, except that the plant was rented while being held for sale. The rental income is apportionable income and the gain on the sale of the plant is apportionable income.

(3) Interest. Interest income is apportionable income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business, or the purpose of acquiring and holding the intangible is related to the operation of the taxpayer's trade or business.

(a) Example: The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are apportionable income.

(b) Example: The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund pertaining to the taxpayer's trade or business and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is apportionable income.

(c) Example: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover items such as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The funds in those accounts earned interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state, and local tax obligations pertaining to the taxpayer's trade or business. The interest income is apportionable income.

(d) Example: The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is apportionable income.

(e) Example: The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000 which it regularly invests in short-term interest bearing securities. The interest income is apportionable income.
(f) Example: In January, the taxpayer sold all of the stock of a subsidiary for $20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The funds are not pledged for use in the business. The interest income for the entire period between the receipt of the funds and their subsequent utilization or distribution to shareholders is non-apportionable income.

(4) Patent and copyright royalties. Patent and copyright royalties are apportionable income where the patent or copyright with respect to which the royalties were received arose out of or was created in the regular course of the taxpayer's trade or business, or where the acquiring and holding the patent or copyright is or was related to the operation of the taxpayer's trade or business, or contributes to the production of apportionable income of the trade or business.

(a) Example: The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain kinds of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are apportionable income.

(b) Example: The taxpayer is engaged in the music publishing trade or business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its trade or business. Any royalties received on these copyrights are apportionable income.

Section 6. Relationship of Transactional and Functional Tests to the U.S. Constitution. The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income that has no rational relationship with the taxing state. Satisfaction of either the transactional test or the functional test complies with this constitutional requirement, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) be tied to the same trade or business that is being conducted within this state.

Section 7. Expenses Related to Non-apportionable or Nontaxable Income. (1) KRS 141.039(2)(c) requires that any deduction allowed under Chapter 1 of the Internal Revenue Code shall be reduced by expenses directly or indirectly related to nontaxable or non-apportionable income. If actual expenses, including interest, salaries, general and administrative, and other stewardship expenses, is not related directly to the income, one (1) of the following formulas shall be used:

(a) Ratio of non-apportionable and nontaxable assets to total assets times interest expense. Interest expense shall represent all expenses incurred in the stewardship or maintenance of non-apportionable or nontaxable assets. Other expenses may be used which more fairly reflect expenses attributable to the income or assets producing the non-apportionable and nontaxable income. Assets shall be valued at cost, and the investment account shall exclude equity;

(b) Ratio of non-apportionable and nontaxable income to total gross receipts times interest expense, officers' salaries, and general administrative expenses. The sum of these or any reasonable combination of these expenses; or

(c) A flat percentage, one (1) percent to 100 percent, of non-apportionable and nontaxable income. The percentage used shall be reasonable and reflect the expenses attributable to the stewardship or maintenance of the assets producing the income.

(2) KRS 141.039(2)(c) requires a corporation to relate expenses to non-apportionable and nontaxable income. The formulas listed in subsection (1)(a) to (c) of this section for determin-
ing related expenses shall be used by the corporation or assist the corporation in developing a method more suitable to its particular situation.

Section 8. Proration of Deductions. Any allowable deduction that applies to both apportionable and non-apportionable income or to more than one (1) trade or business shall be prorated to those classes of income or trades or businesses by the formulas listed in Section 7 of this administrative regulation.

Section 9. The amendments to this administrative regulation shall apply to tax periods beginning on or after January 1, 2018. (IC-6-1; 1 Ky.R. 138; eff. 12-11-1974; Am. 3 Ky.R. 382; eff. 12-1-1976; 32 Ky.R. 1716; 2284; 33 Ky.R. 59; eff. 8-7-2006; 45 Ky.R. 1301, 2055; eff. 2-1-2019.)