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Kentucky Law Survey: Kentucky Taxation

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Kentucky Taxation

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Certainly the most publicized developments in Kentucky tax law during the current survey period were those legislative reforms adopted by the special session of the Kentucky General Assembly in early 1979. Responding to demands for relief from rising tax burdens, the legislature enacted H.B. 44 to limit the impact of inflation on property taxes.¹ These legislative changes were part of a nationwide wave of tax reform proposals engendered by voter approval of California's Proposition Thirteen in June, 1978. In addition to H.B. 44, this article will examine selected judicial decisions involving the taxation of intercorporate dividends, the sales and use tax, the occupational license tax, and statutory provisions for allocation of corporate income.

I. LIMITATIONS ON PROPERTY TAXES — H.B. 44

A. *Limits on Property Taxes Levied by Bodies Other Than the State*

1. *Real Property Taxes*

The concept of a "compensating tax rate" was introduced in 1965 to prevent enormous increases in real property taxes resulting from the Kentucky Court of Appeals' decision in *Russman v. Lockett*² which required all nonexempt property to be valued for tax purposes at fair cash value. The compensating tax rate which, when applied to the current year's assessment of property subject to taxation in the prior year, would produce revenue approximately equal to that produced in the prior year.³ Between 1965 and 1971, growth in tax reve-

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¹ 1979 (Ex. Sess.) Ky. Acts ch. 25, preamble.

² 391 S.W.2d 694 (Ky. 1965). See Note, *Property Tax Revenue Assessment Levels and Taxing Rates: The Kentucky Rollback Law*, 60 Ky. L.J. 105 (1971).

³ 1965 (1st Ex. Sess.) Ky. Acts ch. 2, § 11 (amending Ky. REV. STAT. ANN. § 132.010(6) (Baldwin 1955) [hereinafter cited as KRSA]). This act became known as

nues could result only from improvements to existing property or the addition of new properties to the tax rolls.⁴ These new properties and improvements were taxed at the same rate as other property.⁵ The net effect of these provisions was to freeze collection of property taxes at a maximum of the 1965 levels, plus amounts attributable to additions of new property and improvements.⁶

In 1972, Kentucky Revised Statutes (KRS) section 132.010(6) was amended to define the compensating tax rate as the rate which, when applied to the 1972 assessment exclusive of net assessment growth as defined in KRS section 132.425, produced an amount of revenue approximately equal to that produced in 1971.⁷ The year before, KRS section 132.425 was amended to provide that "net assessment growth" includes the excess of the total current year's valuation of property over the total prior year's valuation of property.⁸ Thus the term "net assessment growth" included increases in assessment due to valuation increases, as well as increases due to the addition of new properties and improvements to the tax rolls. The net effect of incorporating this new definition of net assessment growth into the new definition of the compensating tax rate was to freeze the effective tax rate at the 1971 rate but to allow revenues to increase with property valuation increases and additions of new property.⁹

With H.B. 44,¹⁰ a new statutory scheme was enacted to limit property tax revenues for 1979-80 and subsequent years. First, counties, cities, urban-county governments, school districts, and special taxing districts are prohibited from levying

the Rollback Law.

⁴ For taxing limits of counties, see KY. REV. STAT. § 68.245 (1971) [hereinafter cited as KRS]; for taxing limits of school districts, see KRS § 160.470(3) (1971).

⁵ KRS §§ 68.245, 160.470(3) (1971). For a more detailed description of the application of the Rollback Law to various taxing authorities, see 74 Op. Ky. Att'y Gen. 393 (1974).

⁶ See generally Note, *supra* note 2.

⁷ 1972 Ky. Acts, ch. 285, § 1.

⁸ 1970 Ky. Acts, ch. 260, § 1. Prior to this amendment, only improvements and new properties added to the tax rolls constituted net assessment growth. 1965 (1st Ex. Sess.) Ky. Acts., ch. 2, § 7.

⁹ See generally 74 Op. Ky. Att'y Gen. 455 (1971).

¹⁰ 1979 (Ex. Sess.) Ky. Acts, ch. 25.

a tax rate for 1979-80 which will produce more revenue, exclusive of revenue from net assessment growth, than would be produced by application of the maximum tax rate which could have been levied in 1978-79 on the 1978-79 assessment (hereinafter referred to as "maximum tax rate").¹¹ The maximum tax rate limitation is like the 1972 compensating tax rate limitation in that it restricts additional revenue to that produced by application of a maximum tax rate to net assessment growth, assuming the 1978-79 tax rate was set at its maximum limit. In succeeding years the maximum tax rate is that rate which will produce no more revenue, exclusive of revenue from net assessment growth, than was produced in the preceding year.¹²

This limitation of the tax rate in the current year to a rate which will produce current revenue, exclusive of revenue produced by net assessment growth, equal to the amount of revenue produced in the prior year does not, by itself, limit increases in taxes and revenue resulting from higher property valuations. That result was accomplished by a second limitation which in general prohibits a county, city, urban-county government, school district, or special taxing district from levying a tax rate which exceeds the compensating tax rate.¹³ The definition of compensating tax rate was amended to mean the rate applied to the current year's assessment of property subject to taxation, excluding new property¹⁴ and personal property, which will produce revenue approximately equal to that produced in the preceding year from real property.¹⁵ Like the statutory taxing scheme enacted in 1965, H.B. 44 limits the growth in revenue to that resulting from the addition of

¹¹ KRSA § 68.245(1) (Baldwin 1979) (counties); KRSA § 132.023(1)(a) (Baldwin 1979) (special taxing districts); KRSA § 132.027(1)(a) (Baldwin 1979) (cities and urban-county governments); KRSA § 160.470(2) (Baldwin 1979) (school districts).

¹² KRSA § 68.245(1) (Baldwin 1979) (counties); KRSA § 132.023(1)(b) (Baldwin 1979) (special taxing districts); KRSA § 132.027(1)(a) (Baldwin 1979) (cities and urban-county governments); KRSA § 160.470(2) (Baldwin 1979) (school districts).

¹³ KRSA § 68.245(2) (Baldwin 1979) (counties); KRSA § 132.023(2) (Baldwin 1979) (special taxing districts); KRSA § 132.027(2) (Baldwin 1979) (cities and urban-county governments); KRSA § 160.470(3) (Baldwin 1979) (school districts).

¹⁴ KRSA § 132.010(8) (Baldwin 1979) defines "new property" to include various types of improvements to residential and non-residential real property.

¹⁵ KRSA § 132.010(6) (Baldwin 1979).

new property and improvements to existing property. Under this second limitation, an increase in property values in the current year will require a reduction in the tax rate so that the increase in property values other than that attributable to new property and improvements to existing property will not increase total current revenues to an amount greater than the amount of revenue produced in the prior year. The purpose of this limitation was to provide relief from rising tax burdens attributable to inflated real property valuations.¹⁶

As an exception to this limitation H.B. 44 permits a county, city, urban-county government, school district, or special taxing district to levy a tax at a rate higher than the compensating tax rate (but not higher than the maximum tax rate limitation) if the taxing body holds a public hearing before levying the higher tax.¹⁷ Still, that portion of the tax rate levied which will produce revenue from real property, exclusive of revenue from new property and improvements to existing property, in excess of four percent over the amount of revenue produced by the compensating tax rate from real property is subject to recall vote or reconsideration by the taxing authority.¹⁸ Thus, total real property tax revenues may be increased following a public hearing by as much as four percent if supported by increased assessment values of like amount, or by even greater amounts subject to recall vote and reconsideration.

2. *Personal Property Taxes*

Arguably a local taxing authority may not tax tangible personal property at a rate different than that imposed on real property.¹⁹ Thus, the limits on real property tax rates mandated by H.B. 44 also appear to be applicable to the tax

¹⁶ 1979 (Ex. Sess.) Ky. Acts, ch. 25, preamble.

¹⁷ KRSA § 68.245(5) (Baldwin 1979) (counties); KRSA § 132.023(3) (Baldwin 1979) (special taxing districts); KRSA § 132.027(3) (Baldwin 1979) (cities and urban-county governments); KRSA § 160.470(10) (Baldwin 1979) (school districts).

¹⁸ KRSA § 68.245(6) (Baldwin 1979) (counties); KRSA § 132.023(4) (Baldwin 1979) (special taxing districts); KRSA § 132.027(4) (Baldwin 1979) (cities and urban-county governments); KRSA § 160.470(11) (Baldwin 1979) (school districts).

¹⁹ See Ky. Const. §§ 171, 181; 60 Op. Ky. Att'y Gen. 807 (1960).

rate imposed on personal property by counties, cities, urban-county governments, school districts, and special taxing districts. Thus, even though the compensating tax rate and provisions for recall are based on real property tax rates,²⁰ those tax rates finally determined applicable to real property also should apply to personal property.

The combination of this required uniformity of tax rates and the compensating rate limitation on real property tax levies could result in a reduction of the rates imposed on real and personal property solely because of increases in the valuation of real property. On the other hand, decreases in the value of real property could result in increases in the tax rates on both real and personal property. If fluctuations in the value of real property are accompanied by comparable fluctuations in the value of personal property, both in size and direction, owners of personal property will get no special benefit and suffer no special detriment by basing the personal property tax rate on the rate of tax allowed for real property.

B. *Limits on Property Taxes Levied by the State*

The Kentucky state tax on real property is levied at a rate of thirty-one and one-half cents per one hundred dollars of value.²¹ H.B. 44 provides that this rate be reduced to compensate for any increase in the aggregate assessed value of real property to the extent that such increase exceeds the preceding year's assessment by more than four percent.²² If the assessed value of all real property decreases from the preceding year, the tax rate is to be increased to provide approximately the same amount of revenue as was derived in the preceding year.²³

In periods of inflation, revenue from real property taxes may be expected to increase automatically at a rate of four percent per year. If assessed values increase by more than that amount annually, the state tax rate on real property may

²⁰ See KRSA § 132.010(6) (Baldwin 1979).

²¹ KRS § 132.020(1) (Supp. 1978).

²² KRSA § 132.020(6) (Baldwin 1979).

²³ *Id.*

decline somewhat, but total tax burdens will continue to rise by four percent. The state tax rate of forty-five cents per one hundred dollars of value of tangible personal property²⁴ is not subject to reduction because of any valuation increases.

II. JUDICIAL DEVELOPMENTS

A. *Intercorporate Dividends*

KRS section 141.010(12)(b) excludes from gross income dividends received by a corporation after December 31, 1969. In *Refiners Oil Corporation v. Department of Revenue*,²⁵ the Kentucky Court of Appeals held that the exclusion for intercorporate dividends exempts dividends as defined by Kentucky law rather than by the Internal Revenue Code.²⁶ There is no definition of dividend income in the Kentucky tax statutes. KRS section 271A.225, which restricts a board of directors to declaring and paying dividends in cash or property only out "of unreserved and unrestricted earned surplus, or out of the unreserved and unrestricted net earnings of the current fiscal year and the next preceding fiscal year taken as a single period,"²⁷ however, arguably provides a definition. The Internal Revenue Code utilizes a broader definition, defining dividends as "any distribution of property by a corporation to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year"²⁸

Refiners received substantial distributions on stock it owned in Plantation Pipeline Company (Plantation). The amount of the distribution exceeded Plantation's current and accumulated earnings and profits for federal tax purposes, such earnings and profits reflecting the use of accelerated de-

²⁴ KRSA § 132.020(1) (Baldwin 1979).

²⁵ No. 78-CA-846-MR (Ky. Ct. App. Feb. 23, 1979), *discretionary review granted sub nom.* Department of Revenue v. Refiners Oil Corp., 589 S.W.2d 895 (Ky. 1979).

²⁶ No. 78-CA-846-MR, slip op. at 4 (Ky. Ct. App. Feb. 23, 1979).

²⁷ KRS § 271A.225(1)(a) (Supp. 1978). Prior to adoption of the new Kentucky Business Corporation Act, 1972 Ky. Acts ch. 274, the comparable statutory provision was codified at KRS § 271.265 (1971).

²⁸ I.R.C. § 316(a).

preciation.²⁹ The amount distributed in excess of Plantation's earnings and profits was reported by Refiners in 1970 for federal tax purposes as return of capital and capital gain.³⁰ In subsequent years such excess was treated for federal tax purposes as capital gain because Refiners had recovered its entire basis in its stock in Plantation. Although these distributions exceeded Plantation's earnings and profits as defined for federal income tax purposes,³¹ the distributions did not exceed Plantation's unreserved and unrestricted earnings of the then current fiscal year and the preceding fiscal year taken as a single period.³² The retained earnings for the current and preceding year were higher than earnings and profits because Refiners used straight line depreciation in computing its retained earnings but utilized accelerated depreciation to compute its earnings and profits.³³

The Kentucky Board of Tax Appeals held that the Department of Revenue correctly adopted the federal tax law definition of dividends and, therefore, disallowed exclusion of those portions of the distributions reported by Refiners for federal tax purposes as return of capital and capital gain — that is, in excess of Plantation's earnings and profits.³⁴ The Board of Tax Appeals concluded that since there was no definition of dividends for Kentucky tax law purposes, KRS section 141.050(1),³⁵ which previously had been interpreted as re-

²⁹ *Refiners Oil Corp. v. Department of Revenue*, 2 Ky. TAX REP. (CCH) ¶ 201-386 at 10,853-54 (Ky. B.T.A. 1976).

³⁰ *Id.* at 10,853. Distributions to shareholders are treated for federal tax purposes as dividends to the extent of current and accumulated earnings and profits, any excess being treated either as a return of capital which reduces the shareholder's basis in his shares, or as gain on the sale or exchange of such shares to the extent of amounts in excess of the shareholder's basis. I.R.C. § 301(c).

³¹ 2 Ky. TAX REP. (CCH) ¶201-386 at 10,853. There is no comprehensive definition of "earnings and profits" in the Internal Revenue Code, but I.R.C. § 312 does state the effects of certain transactions on earnings and profits, and the regulations go further in defining that term. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.03 (3rd ed. 1971).

³² *Refiners Oil Corp. v. Department of Revenue*, No. 78-CA-846-MR, slip op. at 3.

³³ 2 Ky. TAX REP. (CCH) ¶ 201-386 at 10,854 (Ky. B.T.A. 1976).

³⁴ *Id.*

³⁵ This statute provides:

Except to the extent required by differences between this chapter and

quiring the application of federal laws and rules not inconsistent with Kentucky laws,³⁶ mandated the use of the federal tax law definition. On appeal from a circuit court judgment upholding the Board of Tax Appeals' decision, the court of appeals disagreed and held that the definition of dividends contained in KRS section 271A.225, the section detailing the funds out of which a board of directors may declare and pay dividends, must be used since Kentucky's method of taxation of intercorporate dividends is inconsistent with their treatment under federal tax law.³⁷ The entire distribution, therefore, including those portions treated as a return of capital and a capital gain for federal tax purposes, was excludable under KRS section 141.010(12)(b) as an intercorporate dividend.³⁸

The court of appeals' decision presents several problems, one of which is its conclusion that the entire distribution should be treated as a dividend, including the portion representing a return of capital.³⁹ KRS section 141.010(12) excludes intercorporate dividends from "gross income."⁴⁰ A portion of

the Federal income tax law and it[s] application, the administrative and judicial interpretations of the Federal income tax law, computations of gross income and deductions therefrom, accounting methods, and accounting procedures, for purposes of this chapter shall be as nearly as practicable identical with those required for Federal income tax purposes.

KRS § 141.050(1) (Supp. 1978).

³⁶ *Koehler v. Commonwealth*, 432 S.W.2d 397, 398 (Ky. 1968). On appeal to the court of appeals from a circuit court judgment affirming the Board of Tax Appeals' decision, both Refiners Oil and the Department of Revenue relied on *Brown v. Department of Revenue*, 558 S.W.2d 635 (Ky. Ct. App. 1977). The court in *Brown* refused to allow the taxpayer to deduct losses incurred by the Subchapter S corporation in which he was a shareholder. In light of the overall scheme and purposes of the Kentucky income tax law, which is to disallow Subchapter S treatment, the court refused to interpret Kentucky law as including any of the federal Subchapter S provisions, notwithstanding that the federal provisions permitting flow-through of Subchapter S losses to shareholders were not negated specifically by the Kentucky income tax statutes for the years in question. 558 S.W.2d at 637-39.

³⁷ No. 78-CA-846-MR, slip op. at 3-4.

³⁸ *Id.* at 4.

³⁹ While the court does not explicitly state that Refiners should be allowed to reduce its gross income by the full amount of the distribution, including that portion which was not includible in its gross income because it constituted a return of capital, such a conclusion seems required by the court's reversal of the circuit court judgment upholding the decision by the Kentucky Board of Tax Appeals. *See id.* at 2, 4.

⁴⁰ KRS § 141.010(12) (Supp. 1978).

the distribution received by Refiners represented a return of capital,⁴¹ however, and therefore was not includible in its gross income. Since this portion of the distribution was not includible in Refiners' gross income it could not be excluded without turning the exclusion into a deduction. Clearly KRS section 141.010(12)(b) was not intended to allow *deduction* of amounts in excess of those included in gross income by reason of intercorporate distribution. Hence, only that portion of the distribution not representing a return of capital should be excludible regardless of the definition applied.⁴²

A more difficult problem is the court's conclusion that the Kentucky and federal statutory schemes are inconsistent, thereby requiring the use of a state law definition.⁴³ Although the court did not recount the discrepancies, one difference between the two statutory schemes is that under Kentucky income tax law, intercorporate dividends are excluded entirely from the recipient's gross income,⁴⁴ but under federal law the recipient of intercorporate dividends is allowed, in general, a deduction equal to eighty-five percent of the dividends received.⁴⁵ That Kentucky law treats dividends differently than does federal tax law, however, does not preclude resort to the federal tax law definition of a dividend. The difference in tax treatment of dividends under Kentucky and federal income tax laws does not necessarily render the two statutory schemes inconsistent, thus requiring the use of different definitions. Moreover, use of the federal tax law definition of dividends arguably is consistent with the purpose of Kentucky tax law.

If the purpose of Kentucky tax law is to exclude from income only that portion of intercorporate distributions which are includible in the corporate distributee's gross income as "dividend income," use of the federal tax law definition of dividend income is consistent with Kentucky tax law purposes. On the other hand, if the purpose of the Kentucky ex-

⁴¹ 2 KY. TAX. REP. (CCH) ¶ 201-386 at 10,853.

⁴² See also *id.* at 10,855.

⁴³ No. 78-CA-846-MR, slip op. at 3-4.

⁴⁴ KRS § 141.010(12)(b) (Supp. 1978).

⁴⁵ I.R.C. § 243.

clusion for intercorporate dividends is to make non-taxable under Kentucky income tax law all intercorporate distributions out of earned surplus, including distributions treated as capital gain under federal income tax law, then use of the federal tax law definition for Kentucky income tax purposes is inappropriate.

For example, assume Plantation distributed \$100 to Refiners on shares owned by Refiners in Plantation. Further, assume that Plantation had earnings and profits of \$30 and an earned surplus of \$100, and that Refiners' basis in the Plantation shares is \$60. Under federal income tax law and the position advanced by the Department of Revenue, Refiners has received \$30 of dividend income, \$60 return of capital and \$10 of capital gain.⁴⁶ Refiners' gross income from this transaction is \$40. Under the court of appeals decision the entire \$100 is dividend income since there was sufficient earned surplus from which the dividend could have been paid under KRS section 271A.225. Although for federal tax law purposes \$10 of the distribution is treated not as dividend income but instead as income from the sale or exchange of property and taxed at favorable long term capital gains rates,⁴⁷ Kentucky income tax law does not provide favorable treatment for long term capital gains received by a corporation.⁴⁸ Thus, if the federal tax law definition of dividend is incorporated into Kentucky law that portion of intercorporate distributions representing capital gains will receive less favorable treatment under Kentucky

⁴⁶ I.R.C. § 301(c).

⁴⁷ Long term capital gains are taxable to corporations in the same manner as ordinary income or at a rate of 28%, whichever is more favorable to the taxpayer. I.R.C. § 1201(a). The 28% alternative corporate tax on long-term capital gains may be more favorable than taxation as ordinary income if the effective tax rate on corporate income exceeds 28%. See generally [1979] 6 FED. TAXES (P-H) ¶ 32,011(b). For taxable years beginning in 1971 or later and ending before January 1, 1979, the alternative rate was 30%.

Because of the 85% dividends received deduction, however, characterization of income as capital gains is generally less favorable under federal income tax law than if it is characterized as dividend income. For example, if a corporation in the 46% tax bracket had \$100 of dividend income it would pay \$6.90 tax on such dividend income. If that same corporation received \$100 of long-term capital gains income its tax would be \$28. I.R.C. § 1201 (alternative tax).

⁴⁸ But see KRS § 141.010(12)(d) (Supp. 1978) (gains on disposal of coal).

law than under federal law. Arguably, the exclusion for intercorporate dividend income was not intended to create more onerous Kentucky income tax burdens on intercorporate distributions than are imposed by the federal income tax law. The unfavorable Kentucky income tax treatment of the \$10 gain, however, is not caused by the Kentucky exclusion for intercorporate dividend income, but rather results from the failure of Kentucky income tax laws to give special treatment to long-term capital gains realized by corporations.

This inconsistency of treatment of intercorporate distributions—*i.e.*, capital gains under federal tax law as opposed to ordinary income under Kentucky tax law, an 85% dividends received deduction under federal law as opposed to 100% exclusion under Kentucky law—should not require the use of a state law definition for dividend income different than the federal law definition. If, however, rules of statutory construction were violated or the legislative intent would be thwarted by the use of the federal law definition then the state definition should apply.

The rule of statutory construction that tax statutes are to be interpreted most favorably to the taxpayer⁴⁹ provides little assistance, as adoption of a local law definition of dividend income different from that in the federal tax law would benefit some taxpayers and burden others. For example, an intercorporate distribution might be declared and paid out of earnings and profits and thus be includible in gross income, but not be a dividend under Kentucky or applicable local law and therefore not excludible.⁵⁰ While adoption of the Kentucky law definition in *Refiners Oil* benefited the taxpayer, if the distribution was unlawful under applicable local law,⁵¹ or was declared by the board of directors out of capital surplus,⁵² or was a stock redemption or liquidation distribution treated as a dividend for federal tax law purposes,⁵³ it would not be ex-

⁴⁹ 3 J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 66.01 (4th ed. 1974).

⁵⁰ See B. BITTKER & J. EUSTICE, *supra* note 31, at ¶ 7.02.

⁵¹ See B. BITTKER & J. EUSTICE, *supra* note 31, at ¶ 7.02.

⁵² See, *e.g.*, KRS § 271A.230 (Supp. 1978).

⁵³ See I.R.C. §§ 302(d), 316(a)(2), 346.

cludible under Kentucky law, yet it might be excludible if the federal definition were adopted. Even if adoption of the local law definition of dividends were favorable to all taxpayers it is arguable that since KRS section 141.010(12)(b) provides an exemption from taxation it should be strictly construed in favor of the taxing authority.⁵⁴

Legislative intent also is useful in determining the scope of the intercorporate dividend income exclusion. The court of appeals in *Refiners Oil* without hesitation noted that "[t]here is no reason to doubt that in enacting the post-December 31, 1969 dividend exclusion the General Assembly intended to exclude all true dividends as defined under Kentucky law."⁵⁵ Presumably the court meant dividends as defined under KRS section 271A.225.⁵⁶ There are, however, a number of reasons for questioning the correctness of this conclusion.

KRS section 271A.225 arguably does not provide a definition of "dividend" but merely describes dividends which the board of directors legally may declare. Even if KRS section 271A.225 can be construed as defining "dividend," the exclusion under KRS section 141.010(12)(b) is for "dividend income" and not for "dividends." It seems reasonable to conclude that the General Assembly intended for different definitions to govern a board of directors' power to declare and pay dividends and a corporation's ability to exclude certain intercorporate distributions as dividend income. For example, it seems questionable that in enacting an exclusion for dividend income that the General Assembly solely was contemplating dividends which a board of directors legally might declare under Kentucky law. If, for example, a corporation in-

⁵⁴ 3 J. SUTHERLAND, *supra* note 49, at § 66.09.

⁵⁵ No. 78-CA-846-MR, slip op. at 4.

⁵⁶ The court of appeals found that the distributions were out of unreserved and unrestricted earnings of the current and next preceding fiscal year and did not render Plantation insolvent or diminish its capital. This is the test determining the authority of the board of directors to declare a dividend under KRS § 271A.225. The court of appeals also stated that "[t]he distributions were clearly dividends as defined under the only Kentucky statute defining dividends." *Id.* at 3.

Prior to the adoption of the new Kentucky Business Corporation Act, 1972 Ky. Acts, ch. 274, the comparable statutory provision was codified at KRS § 271.265 (1971).

corporated in Illinois makes a cash distribution to a Kentucky corporation, did the legislature intend to allow the Kentucky corporation to exclude the distribution from its income only if the distribution could qualify as a legal dividend under KRS section 271A.225? One problem with the court of appeals' conclusion that the General Assembly intended to adopt the definition contained in KRS section 271A.225 is that Kentucky corporations now are forced to analyze corporations' financial statements to determine whether distributions made by the foreign corporations meet the definition contained in KRS section 271A.225.

The legislative history, although sparse, supports the choice of federal law rather than the KRS section 271A.225 definition of dividend income. Prior to 1954 the Kentucky income tax statutes defined a "dividend" as any distribution made by a corporation out of current or accumulated earnings and profits.⁵⁷ In 1954 this definition was deleted from the Kentucky statute along with other provisions giving special treatment to corporate distributions under Kentucky income tax law⁵⁸ in order to achieve greater uniformity between Kentucky and federal income tax laws.⁵⁹ Since the bill establishing the intercorporate dividend exclusion was an income tax law,⁶⁰ it is arguable that the legislature was considering dividends as defined for income tax purposes. The only relevant definition of dividend income at that time was contained in the federal income tax law.

Other considerations mandate adoption of the federal definition. The federal tax law treatment of dividend income is sufficiently complex without the additional complexity en-

⁵⁷ 1936 (3d Ex. Sess.) Ky. Acts ch. 7, § 1.

⁵⁸ 1954 Ky. Acts, ch. 79, § 1. See Allphin, *1954 Kentucky Tax Legislation*, 43 Ky. L.J. 76, 80 (1955).

⁵⁹ In 1954, Kentucky adopted whole-heartedly the theory that the state income tax ought to conform as nearly as possible to the federal income tax. Since then the law has been amended frequently to keep it tied explicitly to the changing federal income tax. Definitions have been revised frequently by adopting those in the Internal Revenue Code.

KY. LEGISLATIVE RESEARCH COMM'N, STATE-FEDERAL INCOME TAX CONFORMITY IN KENTUCKY, RESEARCH REP. No. 8, at 2 (1961).

⁶⁰ 1970 Ky. Acts, ch. 216.

gendered by adoption of a state law definition of dividend income. Adoption of a state law definition would raise many issues involving the scope of that definition and its interaction with the federal tax law treatment of dividend income. Since use of the federal tax law definition is consistent with the legislative intent and purpose of KRS section 141.050(1), Kentucky should not use a local law definition of dividend income different from the federal definition.

B. *Sales and Use Tax*

Purchases of machinery for new and expanded industry are exempted from the sales and use tax under KRS section 139.480(8).⁶¹ To qualify for the new and expanded industry exclusion, the machinery or equipment must be used directly in the manufacturing or production process, be incorporated into plant facilities for the first time, and not be used to replace existing machinery.⁶² Recent cases considering this exemption have focused on the requirement that qualifying machinery be used directly in the manufacturing process.⁶³ In the most recent of these decisions, *Department of Revenue v. State Contracting and Stone Co.*,⁶⁴ the Kentucky Supreme

⁶¹ KRS § 139.480(8) (Supp. 1978).

⁶² KRS § 139.170 (Supp. 1978). Regulations issued by the Department of Revenue defining the new and expanded industry exemption provide:

The machinery and the appurtenant equipment necessary to the completed installation of such machinery, together with the materials used directly in the installation of such machinery and appurtenant equipment, which are incorporated for the first time into new or existing plant facilities, or which are installed in the place of existing plant machinery having a lesser productive capacity, and which are directly used in a manufacturing or processing production operation shall be exempt from the sales and use tax. 103 KAR 30:120(1) (1979).

⁶³ *Ross v. Greene & Webb Lumber Co.*, 567 S.W.2d 302 (Ky. 1978); *Department of Revenue v. Kuhlman Corp.*, 564 S.W.2d 14 (Ky. 1978) (*per curiam*). For a discussion of these cases see Whiteside & Harman, *Kentucky Law Survey- Kentucky Taxation*, 67 Ky. L.J. 739, 748-51 (1978-79).

⁶⁴ 572 S.W.2d 421, 423 (Ky. 1978). In 1974 the General Assembly amended KRS § 139.480 to exclude purchases of pollution control equipment from the sales and use tax. 1974 Ky. Acts, ch. 137, § 2. In order to qualify for the exemption, the taxpayer must obtain a pollution control tax exemption certificate from the Kentucky Department for Natural Resources and Environmental Protection. KRS §§ 224.850-.852 (Supp. 1978). Equipment eligible for the exclusion includes any device or system installed for the primary purpose of reducing or eliminating the emission of air, water,

Court held that pollution control equipment and hot-mix storage bins purchased by the taxpayer for use in an asphalt manufacturing and limestone quarrying business were directly involved in the production process and therefore exempt from sales and use tax under KRS section 139.480(8).

The pollution control equipment was installed in State Contracting and Stone Co.'s Hartford, Kentucky plant to regulate dust emissions from a limestone crusher and to bring the crusher into conformity with federal standards. The addition of the pollution control devices was mandated by federal law, and without such equipment the crusher would not have continued to operate, forcing the taxpayer to suspend plant operations.⁶⁵ Although the crusher itself was conceded to be involved directly in the production process, the availability of the exemption for the pollution control equipment was challenged by the Department of Revenue on the grounds that the latter was not immediately engaged in the physical manufacture of asphalt. The Court rejected such a literal application of "used directly in the manufacturing process" requirement, holding that the pollution control equipment was a functional prerequisite to the continued operation of the taxpayer's business and therefore qualified for the exclusion.⁶⁶

Of particular significance is the Court's conclusion that the pollution control devices were tax-exempt under KRS section 139.480(8) since they constituted "an *essential* part of the manufacturing process" and were functionally "indispensable" to the continued operation of the crusher.⁶⁷ Previously, no objective meaning had been given to the requirement that purchases qualifying under KRS section 139.480(8) be used

or noise pollutants, or the disposal or conversion of solid waste materials. *Id.* In a recent decision by the Kentucky Board of Tax Appeals, the exemption was denied on the grounds that the equipment in question was not purchased primarily for the purpose of controlling air pollution, but rather as an efficiency measure to increase business income. The applicable test articulated by the Board was not whether the equipment in fact reduced emissions, but whether the items constituted pollution control equipment as defined in KRS § 224.850. *Murphy-Miller Co. v. Department for Natural Resources and Environmental Protection*, 2 Ky. TAX REP. (CCH) ¶ 201-532 (Ky. B.T.A. 1979).

⁶⁵ 572 S.W.2d at 422.

⁶⁶ *Id.*

⁶⁷ *Id.* (emphasis added).

“directly” in the manufacturing process.⁶⁸ If applied in all cases in which taxpayers sought to qualify purchases under the new and expanded industry exemption, a strict standard of necessity or indispensability would ostensibly serve to deny the exclusion to machinery or equipment which, although immediately engaged in the actual production process, was not indispensable to the manufacture of a finished product. Therefore, equipment purchased to increase productivity or improve quality control would arguably be denied tax-exempt status on the grounds that such devices were not essential to the manufacture of a marketable or salable product. Such a result would significantly restrict the economic impact of the new and expanded industry exemption, and would be inconsistent with the legislative intent to promote industrial efficiency and “enhance Kentucky’s competitive position in manufacturing.”⁶⁹ A more reasonable interpretation of the Court’s opinion would apply this restrictive construction of “used directly in the manufacturing process” only where equipment or machinery itself serves no manufacturing function, but is only peripherally related to the principle production process.⁷⁰

The Court next considered the question of the hot-mix storage bins which were installed to stabilize the temperature of the asphalt product and to cross-blend the various component parts of the mixture into a homogeneous finished product.⁷¹ In order to determine whether this equipment was used directly in production the Court attempted to define the boundaries of the asphalt manufacturing process. The major-

⁶⁸ Dictum in an earlier case, *Ross v. Greene & Webb Lumber Co.*, 567 S.W.2d 302, 304 (Ky. 1978), is strongly suggestive of a necessity standard. See *Whiteside & Harman*, *supra* note 63, at 750. The sales and use tax regulations state that qualifying machinery must be “intimately involved in production” and “[t]he fact that machinery is necessary for a manufacturing process does not automatically qualify it for exemption.” 103 KAR 30:120(2) (1979).

⁶⁹ *Department of Revenue v. State Contracting and Stone Co.*, 572 S.W.2d 421, 422 (Ky. 1978); *accord*, *Ross v. Greene & Webb Lumber Co.*, 567 S.W.2d 302, 304 (Ky. 1978); *Commonwealth v. WLEX-TV, Inc.*, 438 S.W.2d 520, 522 (Ky. 1969).

⁷⁰ See *Department of Revenue v. Kuhlman Corp.*, 564 S.W.2d 14 (Ky. 1978) (*per curiam*) (exemption denied for the purchase of a computer on the grounds that the equipment was not attached to production machinery and did not participate in physical production).

⁷¹ 572 S.W.2d at 423.

ity concluded that the asphalt mix was not a finished, marketable product until it had passed through the hot-mix storage bins, and the manufacturing process was incomplete until the mixture had been blended and homogenized.⁷² Accordingly, on the basis of the integrated plant concept adopted in prior cases,⁷³ the majority found the devices to be an integral part of the asphalt manufacturing process and held them exempt from sales and use tax as machinery for new and expanded industry.⁷⁴

In his dissent, Justice Stephenson challenged the exempt status of the hot-mix storage bins, characterizing the equipment as a mere "convenience" added to improve the quality of an "already saleable product" and to enhance profit potential.⁷⁵ In support of his conclusion that the devices were not "directly" involved in the asphalt manufacturing process, Justice Stephenson noted that the taxpayer was able to actively and profitably market an asphalt product prior to installation of the storage bins.⁷⁶ Upholding the exemption in this instance, he concluded, would "effectively abolish the limiting effect of 'used directly in the manufacturing process'" and render tax-exempt "the installation of any equipment or machinery however casually related to the manufacturing process."⁷⁷

⁷² *Id.* at 422-23.

⁷³ While the Court did not explicitly rely on the integrated plant concept, it in fact applied it. The focus of the integrated plant concept is on defining the beginning and the end of the manufacturing process. Once these boundaries have been established, all production processes in between are considered to be "integrated" into the manufacturing scheme, and the requirement that equipment be used directly in production "should not be construed to require the breakdown of the manufacturing process into distinct stages." *Schenley Distillers, Inc. v. Commonwealth*, 467 S.W.2d 598, 599 (Ky. 1971). The manufacturing process has been said to begin when "raw material . . . starts moving in a chain of unbroken, integrated sequence into the plant or mill" and ends with the manufacture of a "generally accepted saleable product." *Ross v. Greene & Webb Lumber Co.*, 567 S.W.2d 302, 304 (Ky. 1978). Thus, machinery employed within this progression constitutes an integral part of the production process and is "directly used in the manufacturing process." *Id.*

⁷⁴ 572 S.W.2d at 422-23.

⁷⁵ *Id.* at 423 (Stephenson, J., dissenting). Justice Sternberg joined in Justice Stephenson's dissent.

⁷⁶ *Id.*

⁷⁷ *Id.*

The dissent's approach as to whether the taxpayer was able to produce a salable product is similar to the majority opinion concerning the pollution control device.⁷⁸ That is, if only equipment or machinery shown to be indispensable to the manufacture of a finished product qualifies for the exemption, then under the approach adopted by the dissent, taxpayers producing a salable product presumably would be forever precluded from qualifying purchases under KRS section 139.480(8). If the new and expanded industry exemption is to continue to function as a means of enlarging productive capacity, however, equipment or machinery engaged in physical production should qualify for the exclusion without regard to its relative importance in the overall manufacturing scheme. Only those devices discharging functions ancillary to the primary production process should be subjected to the limiting consequences of a standard based upon necessity or indispensability.

C. *Occupational License Tax*

Pursuant to authority conferred upon first-class cities by KRS section 91.200(1),⁷⁹ the City of Louisville imposes an occupational license tax on local businesses, trades, and occupations for the privilege of conducting business in the city.⁸⁰ Revenue is derived in part through the imposition of a tax on net profits generated by business activities conducted in the

⁷⁸ See text accompanying notes 67-70 *supra* for discussion of the Court's opinion concerning the pollution control equipment.

⁷⁹ KRS § 91.200(1) (Supp. 1978) provides in part:

[T]he board of aldermen of every city of the first class . . . may by ordinance impose license fees on franchises License fees on a business, trade, occupation or profession for revenue purposes may be imposed . . . on . . . the net profits of all businesses, professions, or occupations from activities conducted in the city

⁸⁰ LOUISVILLE, KY., GEN. ORDINANCES ch. 727 (1978). The constitutionality of the occupational license tax ordinance was upheld in *City of Louisville v. Seebree*, 214 S.W.2d 248 (Ky. 1948), and recent cases have reaffirmed the validity of this holding. *Commissioners of the Sinking Fund v. Estate of Doyle*, 573 S.W.2d 932, 934-35 (Ky. Ct. App. 1978); *Avery Fed. Sav. and Loan Assoc. v. Meyers*, No. CA-219-MR, slip op. at 4 (Ky. Ct. App. Nov. 25, 1977), *appeal dismissed for want of final judgment*, 47 U.S.L.W. 3301 (U.S. Sept. 31, 1978) (No. 78-293).

city.⁸¹ In the most recent challenge to the application of Louisville's occupational license tax ordinance, *Commissioners of the Sinking Fund v. Estate of Doyle*,⁸² the Kentucky Court of Appeals upheld the authority of the Commissioners of the Sinking Fund (Sinking Fund) to tax rental income and gains from the sale of real property held for rental purposes. The principal question addressed by the court was whether the holding of real property for investment purposes constitutes a taxable trade or business within the meaning of the local occupational license tax ordinance and KRS section 91.200.⁸³

The Sinking Fund appealed from a decision by the Jefferson Circuit Court that any enforcement of the occupational license tax against individuals holding rental property would be unconstitutional.⁸⁴ In so holding, the trial court invalidated an administrative regulation issued by the Sinking Fund establishing an exemption for individuals devoting less than thirty percent of their time to the operation and management

⁸¹ LOUISVILLE, KY., GEN. ORDINANCES § 727.02(a), (b) (1978).

⁸² 573 S.W.2d 932, 937 (Ky. Ct. App. 1978). In a related development, the United States Supreme Court dismissed for lack of final judgment an appeal taken from a ruling by the Kentucky Court of Appeals that savings and loan associations are subject to the occupational license taxes levied by Louisville and Jefferson County, and that interest income earned by such institutions on federal securities is not exempt from the tax under 31 U.S.C. § 742. *Avery Fed. Sav. and Loan Assoc. v. Meyers*, No. CA-219-MR (Ky. Ct. App. Nov. 25, 1977), *appeal dismissed for want of final judgment*, 47 U.S.L.W. 3301 (U.S. Sept. 31, 1978) (No. 78-293). The court of appeals expressed agreement with a 1971 opinion by the Kentucky Attorney General concluding that savings and loan associations are subject to local license taxes, and that such a tax does not violate the restrictions on taxation of savings and loan associations contained in KRS § 136.300. 71 Op. Ky. Att'y Gen. 288 (1971). *See also* 71 Op. Ky. Att'y Gen. 518 (1971). The court of appeals further found that the local license tax qualified as a "nondiscriminatory franchise tax" permissible under 31 U.S.C. § 742 (1976). No. CA-219-MR, slip op. at 5. While agreeing that as a matter of law savings and loan associations are subject to the tax and that interest income on federal securities could be taxed without violating federal law, the court of appeals reversed that portion of the trial court's order granting summary judgment on the issue of liability for payment of the tax, holding that a genuine issue of material fact existed as to whether the Sinking Fund was seeking to enforce the tax in a discriminatory manner. *Id.* at 6-7.

⁸³ The occupational license tax ordinance defines "business" as "an enterprise, activity, profession, or undertaking of any nature conducted for gain or profit, whether conducted by an individual, co-partnership, association, or any other entity. . . ." LOUISVILLE, KY., GEN. ORDINANCES § 727.01(c) (1978).

⁸⁴ No. CA-219-MR, slip op. at 2.

of income-producing property.⁸⁵ Various parties cross-appealed from that portion of the trial court's opinion sustaining the authority of the Sinking Fund to tax rental income and gains from the sale of rental property held by any partnership or corporation, whether for business or investment purposes.

While apparently rejecting the trial court's decision that enforcement of the tax against individuals holding rental property would be unconstitutional, the court of appeals agreed that certain forms of individual involvement in rental activity may be sufficiently limited to justify a finding that such individuals are not engaged in a true business venture, and that "it would be neither proper nor administratively feasible to subject such an individual to an occupational tax."⁸⁶ The court concluded that "[s]ome rule is necessary to exclude those individuals who truly are not in 'business' but who have merely invested some savings in rental property and who devote little or no time or effort to 'managing' the property"⁸⁷ and sustained the thirty percent rule adopted by the Sinking Fund as a reasonable method of distinguishing an exempt investment venture from activity constituting a taxable rental business.⁸⁸ The court emphasized, however, that this rule merely establishes a presumption of taxable business activity, subject to rebuttal.⁸⁹

Stating that by their nature partnerships and corporations are "uniquely 'business' organizations," the court of appeals held that such entities may be presumed to be engaged in some form of taxable business endeavor.⁹⁰ As a result, income generated by real property held by partnerships and corporations will be subject to the occupational tax on busi-

⁸⁵ *Commissioners of the Sinking Fund v. Estate of Doyle*, 573 S.W.2d 932, 934 (Ky. Ct. App. 1978). See LOUISVILLE, KY., LICENSE TAX REG. § 3.4(b)(2) (1979).

⁸⁶ 573 S.W.2d at 935.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.* See LOUISVILLE, KY., LICENSE TAX REG. § 3.4(b)(2) (1979).

⁹⁰ 573 S.W.2d at 935. See 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.08, at 32 (rev. ed. 1979). The court's characterization of partnerships and corporations holding rental property is in accord with the license tax regulations issued by the Sinking Fund, which provide that "[a]ll corporations engaged in the rental of real estate or partnerships organized for that purpose shall be considered to be engaged in [taxable] activity." LOUISVILLE, KY., LICENSE TAX REG. § 3.4(b)(3) (1979).

ness profits without regard to the extent or nature of the taxpayers' involvement in the management or operation of the enterprise. In response to arguments that this disparate treatment of partnerships and corporations is unconstitutionally discriminatory,⁹¹ the court noted that Kentucky courts have consistently held that individuals and corporations may be placed in different categories for tax purposes without violating constitutional restrictions.⁹² The court had little difficulty extending this distinction to partnerships as well.⁹³

Discussing the taxation of gains realized on the sale of assets, the court of appeals stated that, inasmuch as "gain on the sale of assets is a natural part of the earnings an individual, a partnership, or a corporation derives from a business," gains realized on the sale of rental property "should be subject to the license tax in the same manner and to the same extent as capital gains are considered to be taxable income for federal taxes."⁹⁴ Consistent with the court's treatment of rental income, the tax presumably would apply to all sales of rental property held by partnerships and corporations, and to those sales of property held by individuals deemed to be engaged in "business" conduct, that is, those who meet the thirty percent rule.⁹⁵ If gains realized on the sale of rental property are to be subject to the occupational tax "in the same manner and to the same extent" as capital gains are taxed for federal income tax purposes, however, the question remains whether the favorable tax treatment given a sale or exchange of capital or quasi-capital assets under federal income tax law should likewise be incorporated into the local taxing scheme.⁹⁶

⁹¹ The cross-appellants argued that the disparate treatment violated Ky. CONST. § 171 which requires taxes to be uniform within classes and Ky. CONST. § 174 which mandates that corporate and individual property be taxed at the same rate.

⁹² 573 S.W.2d at 935-36. See *Flint v. Stone Tracy Co.*, 220 U.S. 107, 158-62 (1910); *Square D Co. v. Kentucky Bd. of Tax Appeals*, 415 S.W.2d 594, 596 (Ky. 1967).

⁹³ 573 S.W.2d at 936.

⁹⁴ *Id.*

⁹⁵ See LOUISVILLE, KY., LICENSE TAX REG. § 3.4(b)(2) (1979).

⁹⁶ "Net profit" is defined by the occupational license tax ordinance to include "the net income from the operation of a business, or enterprise, . . . and shall specifically be equal to and the same as a person's net income for Federal income tax pur-

The court's approach to the issue of taxation of rental income in the hands of non-individuals seems overly simplistic and imposes an undue tax burden on non-individual owners of income-producing real property who often hold such property for the same basic investment purposes as individuals. While the court's treatment of corporations as presumptively business entities probably is correct, this nominal characterization fails to recognize, particularly with respect to partnerships, the legitimate non-business opportunities and purposes underlying many modern forms of non-individual ownership of income-producing real estate. If rental income earned by individuals is to be exempted from occupational tax as investment income on the grounds of limited managerial or supervisory involvement, then non-individuals should be afforded an equal opportunity to demonstrate the investment nature of their ownership in a manner consistent with this standard.⁹⁷ That is, income earned by non-individual owners of rental property devoting less than the minimum amount of time sanctioned by the court in *Estate of Doyle* to the operation

poses" LOUISVILLE, KY., GEN. ORDINANCES § 727.01(j) (1978). Thus, in accord with this definition, individual and non-corporate taxpayers found to be engaged in a taxable rental business within the meaning of the ordinance would arguably be entitled to a deduction from gross income in the amount of 60% of the excess of gain over loss realized upon the sale of qualifying property used in the taxpayer's trade or business. See I.R.C. §§ 1202, 1231. While a corporation owning rental property would not be entitled to a similar deduction from gross income upon the disposition of such assets, the broad language employed by the court in *Doyle* would arguably support the contention that the more favorable tax rates available under federal law should apply to local taxation of gains from the sale of business assets. See I.R.C. § 1201.

⁹⁷ The distinction for tax purposes between investment activity and conduct constituting a trade or business has been well-recognized by the courts. See, e.g., *Whipple v. Comm'r*, 373 U.S. 193 (1963). In the case of rental property, two approaches have developed as to the extent of activity necessary to achieve trade or business status under the federal income tax laws. See Lee, "Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business, 25 TAX LAW. 317, 318-24 (1972). The view followed consistently by the Tax Court is that the rental of a single unit is sufficient to constitute a trade or business. E.g., *Lagreide v. Comm'r*, 23 T.C. 508, 511-13 (1954); *Hazard v. Comm'r*, 7 T.C. 372, 375-76 (1946). Most other courts, however, require that for a trade or business to exist there must be a "continuous, regular and substantial activity in relation to the management of the property." *Union Nat'l Bank v. United States*, 195 F. Supp. 382, 384 (N.D.N.Y. 1961). *Accord*, *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam*, 218 F.2d 603 (2d Cir. 1955). See generally 3B J. MERTENS, *supra* note 90, at § 22.144.

and management of the venture should qualify as non-taxable investment income to the same extent as that earned by individuals. At the very least, non-individuals should be permitted to rebut this now conclusive presumption of business activity approved by the court of appeals.

To avoid the inequities resulting from *Estate of Doyle*, the treatment of rental income for occupational tax purposes should reflect the nature and extent of the taxpayer's involvement in the subject activity, rather than the form of the entity being taxed. To this end, perhaps a more reasonable basis for determining whether rental activity constitutes a taxable trade or business within the meaning of the occupational tax ordinance would be to require that such activity represent the *active* conduct of a business, as opposed to the mere conduct of a business. This distinction is raised throughout the Internal Revenue Code⁹⁸ and, as the cases interpreting and applying the active trade or business requirement suggest, such criteria would arguably shift the focus of inquiry away from the nature of the taxpaying entity, and emphasize the quality of taxpayer involvement in the rental activity in question.

D. Allocation of Corporate Income

Finally, in *Clinton Shirt Corporation v. Kentucky Board of Tax Appeals*,⁹⁹ the Kentucky Court of Appeals was con-

⁹⁸ *E.g.*, I.R.C. §§ 355(b), 761(a)(1). See generally 3 J. MERTENS, *supra* note 90, at § 20.103; Lee, *supra* note 97. The Tax Court has recognized that co-owners may be treated as partners for federal income tax purposes if they actively carry on a trade or business, as distinguished from the mere holding of property for investment purposes. *Rothenberg v. Comm'r*, 48 T.C. 369, 372-73 (1967). In determining that co-owners of rental property were in fact operating as partners under I.R.C. § 761, the Tax Court cited previous decisions emphasizing the substantial and continuous nature of the taxpayer's involvement in the rental activity. 48 T.C. at 373. A corporation will be denied Subchapter S status if it derives more than 20% of its gross income from passive investment income. I.R.C. § 1372(e)(5). This requirement was added to limit Subchapter S treatment to businesses "actively engaged in trades or businesses." S. REP. No. 1007, 89th Cong., 2d Sess., reprinted in [1966] U.S. CODE CONG. & AD. NEWS 2141, 2148. To avoid application of this passive investment income restriction to rental income the corporation must provide "significant services" to the occupants beyond those customarily rendered in connection with rental property. *Treas. Reg. § 1.1372-4(b)(5)(vi)* (1980). See *City Markets, Inc. v. Comm'r*, 433 F.2d 1240 (6th Cir. 1970).

⁹⁹ 533 S.W.2d 84 (Ky. Ct. App. 1978).

fronted with an apparent incongruity among several statutory provisions relating to the requirement that corporate taxpayers allocate for Kentucky income tax purposes business income earned within and without this state. Prior to amendment in 1976,¹⁰⁰ KRS section 141.010(14)(b) and KRS section 141.120(2) required corporations "having income from business activity which is taxable both within and without this state" to allocate and apportion net income as provided in KRS section 141.120.¹⁰¹ For corporations doing business solely in Kentucky, KRS section 141.010(14)(a) provided the applicable definition of taxable net income. In *Clinton Shirt*, the taxpayer sought review of adverse rulings by the Department of Revenue and the Kentucky Board of Tax Appeals, subsequently affirmed by the Franklin Circuit Court, denying allocation of income under KRS section 141.120 on the grounds that taxpayer was doing business solely in Kentucky.¹⁰²

The facts as developed by the Board of Tax Appeals showed that the Clinton Shirt Corporation (Clinton) was incorporated in New York and was a wholly owned subsidiary of Garan, Inc. (Garan), which was located in New York City. Clinton was a clothing manufacturer with a production facility located in Clinton, Kentucky. Officers and management officials of Garan served in similar capacities with Clinton. Sales of Clinton products were made by sales personnel operating out of Garan's New York City offices and who were paid with checks drawn by Garan. The lease for the office space in New York City was held and paid entirely by Garan. Garan charged Clinton and other subsidiaries with an allocated portion of expenses on Garan's account ledgers.¹⁰³ On the basis of these facts, the Board of Tax Appeals determined that the New York office was maintained and controlled exclusively by

¹⁰⁰ 1976 Ky. Acts, ch. 155, §§ 7, 10.

¹⁰¹ KRS §§ 141.010(14)(b) (1971) and 141.120(2) (1971) were amended in 1976 to require corporations having *property or payroll* both within and without the state to apportion net income as provided in KRS § 141.120. 1976 Ky. Acts ch. 155, § 7 (emphasis added).

¹⁰² The Board of Tax Appeals ruling is reported in 2 KY. TAX REP. (CCH) ¶ 201-345, at 10,818 (Ky. B.T.A. 1975).

¹⁰³ *Id.* at 10,819.

Garan¹⁰⁴ and consequently since Clinton did not own or lease any property outside of Kentucky or have a payroll outside of Kentucky, the Board concluded that Clinton was doing business solely in Kentucky and denied allocation.¹⁰⁵ The Board then applied KRS section 141.010(14)(a) as the appropriate measure of taxable net income.¹⁰⁶

In concluding that Clinton was doing business solely within Kentucky, the Board of Tax Appeals applied the rule adopted by the Court in *Luckett v. Heaven Hill Distilleries, Inc.*¹⁰⁷ Holding that income derived from sales negotiated through offices maintained by the taxpayer outside of Kentucky was not allocable to Kentucky for income tax purposes, the Court in *Heaven Hill Distilleries* stated: "To avoid allocation of out-of-state sales to Kentucky, the taxpayer must not only negotiate the sales outside of Kentucky but must in addition thereto negotiate them from offices, agencies and places of business *maintained* by the taxpayer outside of the state."¹⁰⁸ The court of appeals in *Clinton Shirt* held that the trial court and the Board of Tax Appeals had correctly applied the standard enunciated in *Heaven Hill Distilleries*, since the New York office was under the exclusive management and control of the parent corporation, Garan.¹⁰⁹

The taxpayer further contended that allocation was required under KRS section 141.120(2) because Clinton paid an annual franchise tax to the state of New York. KRS section 141.120(3), at the time of the dispute, provided in part that "a

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 10,819-20.

¹⁰⁶ *Id.*

¹⁰⁷ 336 S.W.2d 584 (Ky. 1960).

¹⁰⁸ *Id.* at 585 (emphasis in original). See *Luckett v. Coca-Cola Bottling Co.*, 310 S.W.2d 795 (Ky. 1958). Allocation was denied in *Heaven Hill Distilleries* on the grounds that an Illinois corporation negotiating sales contracts on behalf of a Kentucky corporation pursuant to an exclusive sales agreement was wholly independent of the Kentucky corporation, and maintained offices in Illinois over which the Kentucky corporation had no control. Where orders are solicited by sales personnel located in offices outside of Kentucky, but are delivered to offices in this state for approval and processing, it has been held that receipts from such sales will not be allocated to Kentucky for income tax purposes if the sales activity outside the state actually induced or brought about the sale. *Allphin v. Glenmore Distilleries Co.*, 270 S.W.2d 168, 169 (Ky. 1954).

¹⁰⁹ 583 S.W.2d at 86.

corporation is taxable in another state if, in that state it is subject to . . . a franchise tax for the privilege of doing business. . . ."¹¹⁰ Recognizing a possible incongruity between KRS section 141.010(14)(a) and 141.120(2), (3), the court attempted to reconcile these provisions by noting that KRS section 141.120(3) merely made payment of a franchise tax in another state evidence of taxable out-of-state business activity, and for this section to have effect there still must have been income derived from such out-of-state business activity.¹¹¹ Thus,

[E]ven if Clinton were permitted to allocate under KRS § 141.120, since there is no business income derived by it in the state of New York, Kentucky would still receive 100% of Clinton's state corporation income tax obligation. The result to Clinton is the same as if only KRS § 141.010(14)(a) is applied.¹¹²

The Court of Appeals' decision in *Heaven Hill Distilleries* established what seems to be a reasonable and manageable criteria for determining when a corporation will be deemed to have derived income from out-of-state business activity, thereby avoiding allocation of such income to Kentucky for income tax purposes. To the extent that the statutory provisions involved in *Clinton Shirt* conflict, the Court of Appeals was correct in adhering to the approach of *Heaven Hill Distilleries* and denying allocation in this instance. Perhaps in recognition of the apparent conflict created by application of the statutory provisions involved in this case, KRS section 141.120(3) was deleted in 1976.¹¹³

¹¹⁰ KRS § 141.120(3) (1971) was repealed in 1976. 1976 Ky. Acts, ch. 155, § 10.

¹¹¹ 583 S.W.2d at 86-87.

¹¹² *Id.* at 87.

¹¹³ 1976 Ky. Acts, ch. 155, § 10.