STOLL KEENON OGDEN
STATE & FEDERAL TAX PRACTICE

Timothy Eifler
Louisville
502.560.4208
Timothy.Eifler@skofirm.com

Erica L. Horn
Lexington
859.231.3037
Erica.Horn@skofirm.com

Jennifer S. Smart
Lexington
859.231.3619
Jennifer.Smart@skofirm.com

Jackson White
Lexington
859.231.3617
Jackson.White@skofirm.com

Tax Tinkerization - $100M, Really?

Moments before the close of the 2013 Regular Session of the Kentucky General Assembly, both chambers passed House Bill ("HB") 440 - a bill that provides funding necessary for the pension reform measures enacted through Senate Bill ("SB") 2. Reforming the pension system for public employees, a system with $30 billion in unfunded liabilities, was the legislative and gubernatorial priority for the Session. While estimates vary, the general understanding is that approximately $100M annually is needed to fund the pension system. This funding is the subject of HB 440.

A document styled "Governor's Adjusted Proposal – March 26, 2013" outlines three sources of "Funds Available to Pay the Full ARC [Actuarial Required Contribution]": Those sources are as follows:

Description	FY 15 (in millions)	FY 16 (in millions)
General Fund Tax Revenue from reducing personal income tax credit from $20 per person to $10 per person	$32.5	$32.5
Compliance and Technology Efforts	$33.2	$37.4
Impact of Federal Tax Law Changes	$30.0	$30.0
Total	$95.7	$99.9

The "General Fund Tax Revenue" and "Impact of Federal Tax Law Changes" may be addressed summarily. The "Compliance and Technology Efforts", however, are a combination of nine substantive changes, four of which account for the estimated $33.2M increase in revenue in fiscal year 2015 and $37.4M increase in revenue in fiscal year 2016. Finally, HB 440 amends KRS Chapter 138 to permit a trade-in credit when calculating the motor vehicle use tax on new cars. This change results in a revenue *decrease* to the Road Fund of approximately $34M in each fiscal year. One official of the Department of Revenue referred to this change as "sweetener" necessary for consummating the deal.

I. GENERAL FUND TAX REVENUE

Currently, Kentucky provides a tax credit of $20 against individual income tax for each taxpayer and his or her spouse and dependents. For taxable years beginning on or after January 1, 2014, the credit is reduced to $10 per taxpayer, spouse and dependent. No change has been

made to the credits for taxpayers who are over 65, blind or members of the Kentucky National Guard. This 50% reduction in the tax credit is to raise revenue a total of $32.5M per fiscal year.

II. IMPACT OF FEDERAL TAX LAW CHANGES

The American Taxpayer Relief Act of 2012[1] reinstates the limitation on certain itemized deductions. The itemized deductions are reduced by three percent of the amount by which adjusted gross income exceeds a specified threshold. Kentucky's Office of the Budget Director has estimated that reinstatement of the limitation will increase state revenue by $30M.

III. COMPLIANCE AND TECHNOLOGY EFFORTS

The nine substantive changes made to Kentucky's tax code by HB 440, and their estimated revenue impact, are as follows:

Bill Section(s)[2]	Affected Code Section(s)	Description	Revenue Impact FY 15/FY 16 (millions)	Effective Date
2-5	131.1817; 131.190; 186.570; Chapter 186A	Revocation of professional license and driver's license and denial of motor vehicle registration for delinquent taxpayers	$4.0/$6.0	7/1/2013
6-8 and 24	132.010; 132.020; 132.200	Add "broadcast" to property tax definitions; Clarify that 15 cent rate and local exemption applies to radio and television equipment broadcast over the air, but not to telephone and cellular towers; Delete 15 cent rate and local exemption for "telephonic equipment"; Clarify that 15 cent rate and local exemption applies to tangible property certified as a pollution control facility and not any other property	Prevents loss of $2M for each year	1/1/2014

[1] Public Law 112-240,

[2] HB 440 has a total of 28 sections. Sections 1, 10-11, 16, 22-23 and 25-28 are not included in the chart because they do not fall within the "compliance and technology efforts" category or have no fiscal impact on the General Fund. Section 1 makes clarifications regarding installment payment agreements between the Department of Revenue and taxpayers. Sections 10-11 amend KRS Chapter 138 to permit a trade-in credit on purchases of new vehicles when calculating motor vehicle use tax. Section 16 reduces the personal credit described above from $20 to $10. Section 22 amends KRS Chapter 61 to permit receipt of contributions, gifts and donations for the unfunded portion of the retirement fund. Section 23 makes a technical correction to KRS 141.235. Sections 25-28 provide for the effective dates of the provisions of the bill.

Bill Section(s)[2]	Affected Code Section(s)	Description	Revenue Impact FY 15/FY 16 (millions)	Effective Date
9	136.120	Extend public service company property taxation to include wind turbine and solar generating companies	Unknown positive	1/1/2014
12	139.450	Retailers making sales from a place outside of Kentucky for use in Kentucky must notify purchaser of use tax obligation	$3.0/$5.0	7/1/2013
13	139.470	Repeal of exclusion of school tax from gross receipts subject to sales tax for residential telecommunications customers	Unknown positive; less than $500,000	7/1/2013
14	139.480	Clarify that farm machinery includes combines and related equipment	$0.0/$0.0	7/1/2013
15	139.570	Limit vendor compensation to $50 per quarter	$11.2/$11.4	7/1/2013
17	141.205	Revise disclosure requirements for related party transactions to require same disclosure for management fees that currently exists for intangible and interest expenses	$15.0/$15.0	1/1/2014
18 to 21	143.010; 143A.010	Revise definition of "gross value" by removing reference to the Internal Revenue Code	Prevent loss of $3.2M	7/1/2013

A. Revocation of Professional Licenses and Driver's Licenses and Denial of Motor Vehicle Registration

The Department added a new tool to its collection toolbox – revocation of professional licenses and drivers licenses and denial of vehicle registration for "delinquent taxpayers". "Delinquent taxpayers" means:

1. A taxpayer with an overdue state tax liability:

a. That is not covered by a current installment payment agreement;

b. For which all protest and appeal rights under the law have expired; and

c. About which the department has contacted the taxpayer; or

2. A taxpayer who:

a. Has not filed a required tax return with ninety (90) days following the due date of the return, or if the due date was extended, within ninety (90) days following the extended due date of the return; and

b. Was contacted by the department about the delinquent return.

Any delinquent taxpayer who holds a "license", is an attorney licensed to practice law in Kentucky, holds a driver's license, or owns a motor vehicle registered in the state may have their license or driver's license suspended or revoked, and may be denied registration of their motor vehicle. "License" means any occupational or professional certification, license, registration, or certificate issued by a licensing agency that is required to engage in an occupation, profession, or trade in the Commonwealth, other than a license issued to an attorney.

The legislation sets forth the requirements the Department must follow in seeking revocation of a professional or driver's license and denial of registration of a motor vehicle. To begin, twenty (20) days prior to submission of the delinquent taxpayer's name to the licensing agency or Transportation Cabinet, the Department must notify the delinquent taxpayer by certified mail that his or her name will be submitted to the licensing agency (or, for attorneys, to the Kentucky Supreme Court), and the Transportation Cabinet for revocation of a driver's license or denial of registration of a motor vehicle. The notice must include the reason for the action; the amount of any overdue tax liability, including penalties and interest; explain the non-compliance that must be corrected to prevent submission of the taxpayer's name; and list the licenses or registrations for which revocation will be sought.

After expiration of at least twenty (20) days from the date the notice was sent, if the issues identified in the notice were not resolved to the satisfaction of the Department, the Department ***may*** submit the name of the taxpayer to the licensing agency, the Kentucky Supreme Court, if the delinquent taxpayer is a licensed attorney, or the Transportation Cabinet. Once the licensing agency or Transportation Cabinet is notified by the Department that the licensee or motor vehicle owner is a delinquent taxpayer, the licensing agency or Transportation Cabinet shall deny or revoke any license held by the delinquent taxpayer, and the Transportation Cabinet shall prohibit registration of the delinquent taxpayer's motor vehicle. With regard to attorneys, the statute states "the Kentucky Supreme Court [shall decide] appropriate action to enforce Supreme Court Rules".

A delinquent taxpayer who has a license revoked or a motor vehicle registration denied has the right to appeal to the licensing agency or Transportation Cabinet ***if*** the revocation or denial is based upon ***a mistake in facts*** relied upon by the Department, the licensing agency or Transportation Cabinet. A license denied or revoked under the law shall not be reissued or renewed or a motor vehicle registration denied shall not be permitted until a written clearance from the Department is received by the licensing agency or Transportation Cabinet.

B. Property Tax Changes

HB 440 makes three changes to Kentucky's property tax statutes. First, property taxation of broadcast and/or telephonic equipment is changed. Second, the preferential treatment of property that is part of a pollution control facility is narrowed. Third, the definition of "public service company" in KRS 136.120 is expanded to include wind turbine and solar generating companies. To understand the import of the changes made by HB 440 some background is necessary.

1. Background

The state of Kentucky, its counties, cities, school districts and special taxing districts (health departments, library districts and others) (collectively referred to as the "locals") impose property tax on real and tangible personal property.[3] The tax rates assessed by the state are different from the tax rates assessed by the locals. Additionally, each local tax district sets its own rates. The only rates at issue in HB 440 are the rates on tangible personal property. As a general rule, the rate imposed by Kentucky on tangible personal property is 45¢ per $100 of value. Similarly, an estimate of the rate imposed by the locals collectively on tangible personal property is $1.21 per $100 of value.

Certain tangible personal property is taxed at lower state rates and is exempt from local property tax. Included among those types of tangible personal property are "commercial radio, television and telephonic equipment directly used or associated with electronic equipment which broadcasts electronic signals to an antenna" and "property which has been certified as a pollution control facility."[4] These two types of tangible personal property are taxed at a rate of 15¢ per $100 of value by the state and are exempt from all local property taxes. This favored status for property tax purposes can result in a savings of approximately $1.50 per $100 of value, which can be significant in many circumstances. Sections 7 and 8 of HB 440 narrow the definition of "commercial radio, television and telephonic equipment" and "property … certified as a pollution control facility".

2. Commercial Radio, Television and Telephonic Equipment

Beginning with 2005 HB 272 and continuing through 2013 HB 440, the statutes related to property taxation of commercial radio, television and telephonic equipment have changed several times.

a. Taxation before January 1, 2006 through, and including, January 1, 2008.

Telecommunication service providers and cable companies were assessed as public service companies *before* January 1, 2006. This means that the "franchise" of the companies

[3] Most intangible property taxes were repealed effective January 1, 2006. Excluded from the repeal was intangible taxes paid by financial institutions and certain other businesses, such as public service companies. KRS 132.208.
[4] KRS 132.020(1)(j) and (k) and KRS 132.200(5) and (8). KRS 132.020 sets forth the state tax rates on real and tangible property. KRS 132.200 sets forth what property is exempt from local taxation. In most cases where property is taxed at a reduced state rate and is exempt from local tax there will be companion statutes in each statutory section.

was subject to tax in addition to the real and tangible property of the companies. During this time, commercial radio, television and telephonic equipment were entitled to the 15¢ state rate and were exempt from local taxation.

For property assessed *before* January 1, 2009, KRS 132.020(1)(j) and KRS 132.200(5) provided the 15¢ rate and exempt status for commercial radio, television and telephonic equipment directly used or associated with electronic equipment which broadcasts electronic signals to an antenna. For state purposes, KRS 132.020(1)(j) provided for a rate of "Fifteen cents ($0.15) upon each one hundred dollars ($100) of value of all commercial radio, television, and telephonic equipment directly used or associated with electronic equipment which broadcasts electronic signals to an antenna." Similarly, KRS 132.200(5) provided for exemption from local property taxes for "commercial radio, television, and telephonic equipment directly used or associated with electronic equipment which broadcasts electronic signals to an antenna; however, radio or television towers not essential to the production of the wave or signal broadcast shall not be included." At this time, the only difference between the two statutes was the express exclusion of "radio or television towers not essential to the production of the wave or signal broadcast" from KRS 132.200(5).

According to the Department of Revenue, the types of radio and tv equipment that qualified for this favored status included radio and tv equipment used to broadcast radio or tv stations to the public at large for no fee. The types of telephonic equipment within the classification included: "Dense Wavelength Division Multiplexing Equipment II; Modulator II; Multiplex Equipment II; Phase Equalizer II; Antenna (Microwave) III; Antenna (Used in Broadcasting a Signal) III; Microwave Systems III; Radio III; Transmitters III; Transmitter Diplexer III; Transceiver III.

b. Taxation January 1, 2009 through, and including, January 1, 2013.

For assessments made on or after January1, 2009, KRS 132.200 was amended to exempt from local taxation:

> (5) (a) Commercial radio, television, and telephonic equipment used to receive, capture, produce, edit, enhance, modify, process, store, convey, or transmit audio or video content or electronic signals which are broadcast over the air;
>
> (b) Equipment directly used or associated with the equipment identified in paragraph (a) of this subsection, including radio and television towers used to transmit or facilitate the transmission of the signal broadcast, but excluding telephone and cellular communications towers; and
>
> (c) Equipment used to gather or transmit weather information; ….[5]

[5] 2008 KY Acts c. 81, §1 (2008 HB 277).

A parallel change was *not* made to KRS 132.020. Therefore, it is possible that commercial radio, tv and telephonic equipment could have been entitled to the lower state rate but taxable at the local level for tax years 2009 through 2012.

c. Taxation beginning on January 1, 2014.

Sections 6, 7 and 8 of HB 440 amend KRS 132.010, 132.020 and 132.200, respectively, for property assessed on or after January 1, 2014. The first change is the addition to KRS 132.010 of a definition for "broadcast". Section 6 provides:

> *(24) (a) "Broadcast" means the transmission of audio, video, or other signals, through any electronic, radio, light, or similar medium or method now in existence or later devised over the airwaves to the public in general.*
>
> *(b) "Broadcast" shall not apply to operations performed by multichannel video programming service providers as defined in KRS 136.602 or any other operations that transmit audio, video, or other signals, exclusively to persons for a fee.*

The definition makes express the Department's long-standing position that the special treatment of commercial radio, tv and telephonic equipment was intended to be limited to equipment that enabled the public at large to receive radio and television stations for free and telephonic equipment associated with POTS - "plain old telephone service".

Section 7 makes significant changes to KRS 132.020(1)(j). The additions to the statute are in bold, underlined, italicized font and the deletions are in brackets.

> Fifteen cents ($0.15) upon each one hundred dollars ($100) of value of all commercial radio ***and***[~~,~~] television[~~, and telephonic~~] equipment[_~~directly~~] used ***to receive, capture, produce, edit, enhance, modify, process, store, convey, or transmit audio or video content or electronic signals which are broadcast over the air***[~~or associated with electronic equipment which broadcasts electronic signals~~] to an antenna***, including radio and television towers used to transmit or facilitate the transmission of the signal broadcast and equipment used to gather or transmit weather information, but excluding telephone and cellular communication towers***;

The substantive change to KRS 132.020(1)(j) is the deletion from the statute of telephonic equipment. According to a Department of Revenue employee, the Department advocated eliminating favorable treatment for telephonic equipment because of the "tax break" received by telecommunication services companies in 2006 when their franchise was no longer subject to tax.

Finally, Section 8 conforms KRS 132.200(5) to the amended version of KRS 132.020(1)(j). The amendment is as follows:

> (5) (a) Commercial radio ***and***[~~,~~] television[~~, and telephonic~~] equipment used to receive, capture, produce, edit, enhance, modify, process, store, convey, or transmit audio or video content or electronic signals which are broadcast over the air ***to an antenna***;
>
> (b) Equipment directly used or associated with the equipment identified in paragraph (a) of this subsection, including radio and television towers used to transmit or facilitate the transmission of the signal broadcast, but excluding telephone and cellular communications towers; and
>
> (c) Equipment used to gather or transmit weather information;

The primary change to the statute is the elimination of telephonic equipment from the exclusion from local taxation.

3. Property Certified as a Pollution Control Facility

As described above, property certified as a pollution control facility also was taxed at the 15¢ state rate and was exempt from local taxation. In recent protests by taxpayers, arguments had been made extending the property exempt from tax to real and intangible property of certain public service companies. As a result of these arguments, Sections 7 and 8 of HB 440 amend KRS 132.020(1)(k) and KRS 132.200(8) to clarify that the sections apply only to ***tangible personal*** property certified as a pollution control facility.

In a further attempt to defeat the argument of the taxpayers, Section 24 of HB 440 states, "It is the intent of the General Assembly that the changes made … relating to tangible personal property … certified as a pollution control facility, are to clarify existing provisions in the law …." However, it is unclear what effect, if any, this section will have as Section 28 of HB 440 clearly states that Sections 7, 8 ***and 24*** take effect January 1, 2014.

4. MORE Public Service Companies

What started as the imposition statute for the property tax on public utilities has become a special taxing statute for over nineteen different companies ranging from traditional public utilities such as electric power companies to privately owned businesses such as commercial air carriers. HB 440 adds two more types of companies to the public service company property tax statute. Specifically, KRS 136.120(1)(a)(12) is amended to define "electric power companies" as including "wind turbine and solar generating companies". Energy marketers dodged a bullet as the Department of Revenue had sought their inclusion within the public service company ranks before the Blue Ribbon Commission on Tax Reform.

C. Sales Tax Changes

Four changes are made to Kentucky's sales tax statutes by HB 440. Two of the four changes are quite simple. First, KRS 139.480(11) is amended to clarify that the exemption from sales tax for "farm machinery" includes combines and equipment that attaches to combines. Second, the compensation allowed vendors for collecting and remitting the sales tax is reduced to a maximum $50.00 per quarter. Previously, the limit was $1,500 per quarter. This reduction in the limitation is estimated to raise revenue in excess of $11M.

The two other changes include new notice requirements for certain out-of-state sellers; and the repeal of KRS 139.470(9), which results in the utility gross receipts license tax (that is, "school tax") being subject to sales tax for residential telecommunications' customers.

1. Use Tax Notification and Compliance Requirements for Remote Vendors

Kentucky now joins a handful of other states, including Oklahoma, South Carolina, Vermont and South Dakota, in requiring out-of-state sellers to provide notice to their customers of the customer's potential use tax obligation. The Department of Revenue presented this change to the Blue Ribbon Commission on Tax Reform. In its presentation, the Department described its proposal as "the least onerous of concepts" because it only requires sellers to provide notice and not to *collect* the use tax.

Section 12 of HB 440 adds language to KRS 139.450 requiring every retailer making sales of tangible personal property or digital property from outside the state for use in the state and not collecting the use tax to notify the purchaser that the purchaser is required to report and pay the Kentucky use tax directly to the department on purchases from that retailer unless the purchases are otherwise exempt under the sales tax statutes.

The notice must be "readily visible and shall be included on the retailer's Internet Web site, retail catalog, and invoices provided to the purchaser." In addition to other requirements, the notification must include the following language:

> "The retailer is not required to and does not collect Kentucky sales or use tax.";
>
> "The purchase may be subject to Kentucky use tax unless the purchase is exempt from taxation in Kentucky.";
>
> "The purchase is not exempt merely because it is made over the Internet, by catalog, or by other remote means."; and
>
> "The Commonwealth of Kentucky requires Kentucky purchasers to report all purchases of tangible personal property or digital property that are not taxed by the retailer and pay use tax on those purchases unless exempt under Kentucky law. The tax may be reported and paid on the Kentucky individual income tax return or by filing a consumer use tax return with the Kentucky Department of Revenue. These forms and corresponding instructions may be

> found on the Kentucky Department of Revenue's Internet Web site.".

Retailers with annual sales less than $100,000 are exempt from the notice requirements.

The statute raises the ultimate state tax question --- Whether the notice requirement discriminates against interstate commerce and therefore, is unconstitutional under the Commerce Clause. A federal judge in Colorado struck down as unconstitutional that state's reporting requirements imposed on out-of-state vendors. *Direct Marketing Association v. Huber*, D. Colo., No. 1:10-CV-01546-REB-CBS, 3/30/12. The case was appealed by the state to the Tenth Circuit. Briefing has been completed, but no decision has been issued.

However, Colorado's law is more far-reaching than Kentucky's. The Colorado statute required retailers that did not collect sales and use tax to:

> •Notify their Colorado customers that they do not collect Colorado sales tax and, as a result, the purchaser is obligated to self-report and pay use tax to the department;
>
> •Provide an annual report to each of their Colorado customers, detailing their purchases in the previous calendar year, informing the customer that he or she is obligated to report and pay use tax on such purchases and that the retailer is required, by law, to report to the department the customer's name and the total amount of purchases; and
>
> •Provide the department with an annual report concerning each of their Colorado customers, stating the name, billing address, shipping addresses, and the total amount of purchases by each of the retailer's Colorado customers.

While the first bullet mirrors Kentucky's law, the second and third bullets are far more extensive and burdensome. Thus, the question of whether Kentucky's statute can pass constitutional muster is open. The Department has estimated increased revenue of approximately $5M from the new notice requirements.

2. <u>Repeal of the school tax exclusion from the sales tax calculation on "residential telecommunications service" found in KRS 139.470(9)</u>

Enacted in 1979, KRS 139.470(9) excludes from sales tax the charge on the bill of a residential telecommunications customer for the utility gross receipts license tax. Currently, KRS 139.470(9) excludes from sales tax:

> Any rate increase for school taxes and any other charges or surcharges added to the total amount of a residential telecommunications service. For purposes of this section, "residential telecommunications service" means a

> telecommunications service as defined in KRS 139.195 or an ancillary service as defined in KRS 139.195 provided to:
>
> (a) An individual for personal use at a residential address, including an individual dwelling unit such as an apartment; or
>
> (b) An individual residing in an institution such as a school or nursing home if the service is paid for by an individual resident rather than the institution.

HB 440 repeals the section in its entirety.

According to the Department of Revenue, this change is necessitated by an amendment to the definition of "sales prices" in the Streamlined Sales and Use Tax Agreement (SSUTA). The amendment clarifies what types of taxes a state may exclude from sales price. The SSUTA amendment to the definition of "sales price" and accompanying Rule 327.9 specify that states may exclude from sales price those taxes on a retail sale that are 1) separately stated on the invoice …, 2) imposed on the seller, and 3) allowed but not required to be passed on to the customer. The Department maintains that these requirements do not allow Kentucky to continue exempting the school tax from sales tax on residential phone bills and that consumers are unlikely to notice the change in their phone bills.

D. <u>"LOOPHOLE" closure – Require Reporting of Related Party Management Fees in the Same Manner as is Currently Required for Related Party Intangible Expenses and Interest Expenses</u>

In 2005 and 2006, changes to Kentucky's tax statutes included a requirement that related party intangible expenses, interest expenses, and management fees[6] be disallowed as a deduction in calculating corporation income tax unless certain conditions or requirements were met.[7] Currently, a company's related party management fees will not be disallowed if the company meets one of the following tests:

> (5) (a) The entity and recipient are both included in the same consolidated Kentucky corporation income tax return for the relevant taxable year;
>
> (b) The entity makes a disclosure and establishes by a preponderance of the evidence that the transaction giving rise to the management fees between the corporation and the recipient was made at a commercially reasonable rate and at terms comparable to an arm's-length transaction; or

[6] "Management fees" includes but is not limited to expenses and costs paid for services pertaining to accounts receivable and payable, employee benefit plans, insurance, legal, payroll, data processing, purchasing, tax, financial and securities, accounting, reporting and compliance services or similar services, only to the extent that the amounts are allowed as a deduction or cost in determining taxable net income before application of the net operating loss deduction for the taxable year provided under Chapter 1 of the Internal Revenue Code. KRS 141.205(1)(d).

[7] The changes were codified in KRS 141.205. These types of statutes are commonly referred to as "add-back statutes".

(c) The entity and the Department of Revenue agree in writing to the application or use of an alternative method of apportionment under subsection KRS 141.120(9).

KRS 141.205. Most companies meet subsection (b) through the disclosure of a transfer-pricing agreement or study. The agreement establishes that the management fees between the company and the recipient are at a commercially reasonable rate and at terms comparable to an arm's-length transaction. The changes made by HB 440 make this "disclosure test" a subpart of a much stricter test.

The "new" requirements are as follows:

(3) (a) The entity and the recipient are both included in the same consolidated Kentucky corporation income tax return for the relevant taxable year; or

(b) The entity makes a disclosure, and establishes by a preponderance of the evidence that:

1. The payment made to the recipient was subject to, in its state or country of commercial domicile, a net income tax, or a franchise tax measured by, in whole or in part, net income. If the recipient is a foreign corporation, the foreign nation shall have in force a comprehensive income tax treaty with the United States; and

2. The recipient is engaged in substantial business activities separate and apart from the acquisition, use, licensing, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related members, as evidenced by the maintenance of permanent office space and full-time employees dedicated to the maintenance and protection of intangible property; and

3. The transaction giving rise to the intangible interest expense, intangible expense, or management fees between the entity and the recipient was made at a commercially reasonable rate and at terms comparable to an arm's-length transaction; or

(c) The entity makes a disclosure, and establishes by preponderance of the evidence that the recipient regularly engages in transactions with one (1) or more unrelated parties on terms identical to that of the subject transaction; or

(d) The entity and the Department of Revenue agree in writing to the application or use of an alternative method of apportionment under KRS 141.120(9).

KRS 141.205, as amended. Note that subsection (3)(a) is unchanged from (5)(a) and (3)(d) is the same as subsection (5)(c). The big changes are the inclusion of management fees in (3)(b) and (3)(c).

Pursuant to KRS 141.205(3)(b), as amended, in addition to the company establishing a commercially reasonable rate and terms comparable to an arms-length transaction, the company must demonstrate the fees paid to the recipient were subject to, *in the recipient's state or country of commercial domicile*, a tax based on income. Alternatively, the company may avoid disallowance of the management fees if the entity makes a disclosure and establishes by preponderance of the evidence that the recipient regularly engages in the management of one or more unrelated parties on terms identical to the terms between the recipient and the company. These new tests may make it very difficult for a company to avoid the add-back of related party management fees in calculating taxable income.

The new tests in the amended statute will be difficult to satisfy for two reasons. First, a company charging a management fee generally is a management or headquarters company. Establishing that the management or headquarters company paid a tax measured by income in its state of commercial domicile may be a challenge because the state of commercial domicile may not have an income-based tax (e.g., Ohio, which has a tax based on commercial activity), or the management and headquarters companies may be part of a consolidated or combined return in the state of commercial domicile. Second, it is unlikely that a management or headquarters company will be in the business of managing unrelated companies. Because both of these tests create scenarios that may be unlikely, the Department's estimate of a $15M increase in revenue may be realistic.

E. Changes to the Severance Tax

Sections 18-21 of HB 440 amend provisions of the severance tax for coal and other natural resources such as natural gas. The significant change is the deletion of the reference to the Internal Revenue Code ("IRC") when defining "gross value". The severance tax is imposed on the "gross value" received from the severance or *processing* of coal or other specified natural resources. Currently, "gross value" is defined as synonymous with "gross income from property" as defined in IRC § 613(c). Under the federal statute, gross income from property means gross income from mining. The federal statute does not consider *processing* to be gross income from mining unless performed by an owner or operator of a mine. Thus, an argument had been made that processing performed someone other than an owner or operator of a mine is not taxable because the amount of "gross income from mining" is zero, and thus, no severance tax could be due. To foreclose this argument from being made successfully, the General Assembly, when defining "gross value", deleted the reference to the IRC.