Volume 40 | Issue 4 Article 3

1952

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Samuel Milner
University of Michigan

ALLOCATION OF CORPORATE INCOME FOR PURPOSES OF THE KENTUCKY INCOME TAX

By SAMUEL MILNER*

According to information obtained from the Kentucky Chamber of Commerce, in 1950 twenty-seven new major industries located in Kentucky It is estimated that these industries employed 3,387 workers at an estimated annual payroll of $8,467,500, and with an estimated plant investment of $35,761,000. The same source of information reports that in the same year twenty-five major industries expanded their facilities in Kentucky, thus employing an additional 4,890 workers, and providing an additional annual payroll of $12,225,000, with a total estimated value of expansion of $50,073,000.

For 1951, it was reported that thirty-five new major industries located or announced they would locate in Kentucky. The estimated number of workers for these industries was 25,970, with a payroll of $77,910,000, and a plant investment of $846,691,000. In 1951 twenty existing major industries announced expansion, so as to employ 1,964 additional workers with an additional payroll of $5,892,000, and a plant investment totaling $207,918,000.[1]

Many of these new and expanded industries are corporations organized under the laws of other states. Almost all of them, whether foreign or domestic corporations, carry on business both within and without the State of Kentucky. Each of them is confronted with the question of how it will be affected by the Kentucky income tax. If it may be assumed that the increase of industry in Kentucky will continue, the same question will be posed to many additional firms. Thus the incidence of the Kentucky income tax on corporations becomes a most important question, especially to industrial and manufacturing concerns, who by the very nature of their business carry on both *intra* and *inter* state transactions.

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* A.B., Western Kentucky State College; LL.B., University of Kentucky; Legal Research Fellowship, University of Michigan; Member of the Kentucky and United States Treasury Department Bars.

[1] Acknowledgment is gratefully made to Mr. Walter B. Koch, Director of Industrial Development, Kentucky Chamber of Commerce, for this information.

Kentucky imposes an income tax upon domestic corporations and upon foreign corporations doing business in this state, or deriving income from activities or other sources in this state.[2] The tax is imposed upon " the entire net income of the corporation, derived from business done, property located, activities or sources in this state. "[3] Thus, before the tax may be imposed, it must be found that the corporation is either (1) doing business in Kentucky, or (2) is deriving income from "activities" or "other sources" in this state. Even if one or the other of these requirements is met, the tax may then only be imposed on that part of the income specified in the statute as attributable to the corporation's Kentucky operations or transactions. The rate of tax, which is imposed upon " the entire net income of the corporation, or the portion thereof taxable within this state ",[4] was increased from four percent to four and one-half percent by an enactment of the 1950 General Assembly[5]

For purposes of segregating income into the part which is taxable by Kentucky and the part which is not taxable by Kentucky, corporate income is first divided by the statute into non-business and business income.[6] Non-business income is defined to include " income not received in connection with the transaction of the business of the corporation ", such as interest, dividends, royalties and gains from the sale of property not held, owned or used in connection with the business of the organization.[7] This non-business income, if received from sources outside Kentucky, is not taxable by Kentucky; but if received from *intra* Kentucky sources, it is taxable by Kentucky.[8]

All other income of the corporation (with the exception of gains from the sale of securities issued by foreign governments or by corporations organized under the laws of foreign governments) is denominated "business income"[9]

If the trade or business of the corporation is carried on solely

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[2] Kentucky Revised Statutes (1948), Section 141.040.
[3] *Ibid.*
[4] *Ibid.*
[5] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.250.
[6] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (1).
[7] *Ibid.*
[8] *Ibid.*
[9] *Ibid.*

within Kentucky the tax is imposed on the entire business income.[10] If the trade or business is carried on partly within Kentucky and partly outside the borders of Kentucky, the tax is imposed on the portion of business income reasonably attributable to the trade or business within Kentucky[11] and where the income is derived from the manufacture or sale of tangible personal property, the portion of income attributable to Kentucky is determined in accordance with a statutory formula. This formula is made up of three factors: (1) value of tangible property, (2) payroll, and (3) business within this state. Pursuant to the statutory formula, the income taxable by Kentucky is such percentage of the corporation's total income as the value of the tangible property, payroll and business within Kentucky bears to the total of these factors both within and without Kentucky, each of the three factors to be separately determined and the percentages averaged.[12]

Prior to the 1950 Act, only two factors were used in the formula: tangible property and total business. The third factor, payroll, was added by the 1950 Act.[13] At a time when it is the established policy of many organizations within the state to attract industry here in order to create employment and payroll, it seems somewhat anomalous that a change in the law would have been adopted whereby industry is penalized income tax wise for accomplishing that very purpose.

In most instances, it would appear that the "business" factor would prove to be the most important one of the three. The "tangible property" factor should be somewhat minimized in instances where the company owns no real estate in Kentucky, as is usually the case where a municipality or chamber of commerce constructs or procures a building for the industry It would appear that the "payroll" factor would be of relatively lesser importance in instances where large executive salaries are paid by the home office and are not paid to employees " chiefly situated at, connected with, or sent out from premises in this Commonwealth that are used by the corporation in connection with the

[10] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (2).

[11] *Ibid.*

[12] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (3) (b).

[13] *Ibid.*

transacting of business"[14] Some apprehension may be felt as the result of the use of the phrase "connected with" in the last quoted portion of the statute, as all executives of a company may be said to be connected with all of the company s operations. However, it is reasonable to assume that the phrase "connected with" would not be construed to broaden the application of the statute to any degree more than the phrases "chiefly situated at" and "sent out from", since all three phrases have as their delimiting object the phrase *"premises* in this Commonwealth"

It seems also that a corporation could adopt sales and ac counting practices and procedures such as to minimize the "business" factor. Since the pertinent provisions of the law in this re gard is to the effect that sales shall be assigned only to the place of business of the corporation in which the transaction giving rise to the receipts are *chiefly negotiated,*[15] it should be pointed out that the company could avoid "negotiating chiefly" in Kentucky. Prior to the 1950 Act, and at the time the subsequently discussed Tennessee Gas case[16] was decided, the business factor included sales " at the office, agency or place of business " where the " transactions giving rise to the receipts are chiefly handled and attended to with respect to the negotiation and execution"[17] The 1950 Amendment imposes the "chiefly negotiating" criterion, as the sole criterion, and eliminates the place of execution as a factor. The regulations state that the question of where a sale takes place is a question of fact.[18]

Attention is called to that catch-all provision of the law to the effect that the entire formula may be disregarded if, *in the judgment of the Kentucky taxing authority,* use of the formula does not allocate a fair share of the corporate income to Kentucky; or in the event use of the formula results in unconstitutionality.[19] It is also provided that, if in a given case all three factors of the formula are not present, the factors present shall be used.[20]

[14] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (3) (c).

[15] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (3) (f).

[16] *Infra* note 32.

[17] Kentucky Revised Statutes (1948), Section 141.120 (3) (e).

[18] Kentucky Income Tax Law and Regulations (1946), page 73, article 120-3.

[19] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (7).

[20] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (4).

The Court of Appeals has been confronted with six cases pertaining to this phase of the law.

The City of Cincinnati, Ohio, a municipal corporation, owned a railroad, more than 50% of which railroad's total trackage and total property were located in Kentucky. The City of Cincinnati did not operate the railroad, but derived substantial income from a lessee through a rental agreement relating to the railroad. Kentucky sought to impose an income tax upon the rental received by the City of Cincinnati on the theory that Cincinnati was "doing business" in Kentucky. It was held that the tax could be imposed: The Court said that Cincinnati was "doing business" in Kentucky, in view of the fact that it owned tangible property in Kentucky· and the Court also indicated that the decision could be grounded upon the fact that the statute expressly authorized a tax in reference to corporate income derived from property located or sources within Kentucky It was the contention of the City of Cincinnati that it was not doing business in Kentucky; and the Court chose "to meet the issue squarely upon the ground chosen by the appellant" in holding Cincinnati's contention that it was not doing business in Kentucky to be "wholly untenable" As evidence that business was being done in Kentucky, the Court cited the investment of capital, the qualification of a process agent, and the exercise of the power of eminent domain.[21]

The Fourth Avenue Company, a Kentucky corporation owning and operating theatres in Kentucky and Indiana, owned all of the capital stock of the W Company, the latter being an Indiana corporation which operated theatres in Indiana. Kentucky sought to impose an income tax based upon the dividends received by the Fourth Avenue Company upon its stock in the W Company. It was held that the tax could not be imposed. The Court was unwilling to accept the taxing authority s theory that, because the certificates of stock were actually held in Kentucky by the Fourth Avenue Company, the income was taxable in Kentucky. The Court stated that the labor and capital giving rise to the dividends, the source of income, were expended outside of Kentucky The Court said "It is appellants' contention that the three theatres in Terre Haute, Indiana, leased by the Western Indiana Theatres

[21] City of Cincinnati, Ohio v. Commonwealth, 292 Ky. 597, 167 S.W 2d. 709 (1942).

Corporation, were not operated by the appellee which owned none of the leases but owned only the capital stock of the leasing corporation and since the certificates of stock were located in Kentucky, the dividends thereon were received from sources within Kentucky, and were therefore allocable within Kentucky and taxable. The argument substitutes the shadow for the substance. The Indiana corporation was a mere agency or instrumentality of the Kentucky corporation transacting a portion of the latter s business in Indiana. The admitted facts show that the three theatres were merely three links in the chain of thirteen links, were operated as parts of a unified business, and for all practical purposes 'were considered in exactly the same category as any of the other theatres' The stock of the Indiana corporation was not held by appellee as an investment aside from its regular business, in which event appellants argument would be pertinent, but as a means of transacting business in Indiana" It would thus appear that the Court considered the dividend income as "business income", apparently finding it necessary to consider this income as "business income" in order to reach the conclusion that the income was non-taxable by Kentucky.[22]

R.C.A., a Delaware corporation, with its principal offices in New York, entered into a royalty agreement with the Ken Rad Company, also a Delaware corporation (the latter corporation s principal business being in Kentucky), whereby the Ken Rad Company in its manufacturing operations in Kentucky was permitted to use patents belonging to R.C.A. Kentucky attempted to tax R.C.A. upon the income derived by R.C.A. from the Ken Rad Company pursuant to the royalty agreement. It was held that Kentucky could not tax this income. The Court stated that a patent has a tax situs at the domicile of its owner, and that a royalty agreement is simply an agreement not to sue for infringement, and that consequently R.C.A. was not doing business in Kentucky. One of the contentions of the State was that, even if the Court held that R.C.A. was not doing business in Kentucky and that R.C.A. had no property located in Kentucky, yet the royalties payable to R.C.A. arose from sources in Kentucky, but the Court denied this contention, saying that the royalties arose in

[22] Kentucky Tax Commission v. Fourth Avenue Amusement Company, 293 Ky. 668, 170 S.W 2d. (1943).

New York where the contract was signed and where the royalties were payable.[23]

The A Railroad Company, a Virginia corporation with its principal place of business in North Carolina, owned 51% of the stock of the L. & N. Railroad, the latter a Kentucky corporation with its principal place of business in Kentucky. Kentucky sought to tax the A Railroad Company upon the income it derived from dividends upon its stock in the L. & N. Railroad. Thus we have an attempt to tax the income of a foreign corporation received by the latter in the form of dividends upon stock owned in a domestic corporation, the converse of the situation presented in the Fourth Avenue Case.[24] The Court by-passed the question of whether or not the Atlantic Coast Line Company was doing business in this state; and held that the dividends did not constitute income from business done, property located or sources in this state; and thus held that Kentucky could not tax this income. The Court said "We are of the opinion that sources in this state' as used in the Kentucky Statutes does not include the receipt of dividends by a foreign corporation or the stock of a domestic corporation where the stock is held solely as an investment or otherwise and has no fair relation to business done by the foreign corporation or its property located in this state" [25]

The V-C Company, a Virginia corporation, owned 55% of the capital stock of the T Company, the latter a Delaware corporation with its principal office and manufacturing plant in Kentucky. Kentucky sought to tax the V-C Company on the income it derived from dividends upon its stock in the T Company. It would appear that the principal characteristic distinguishing this case from the Atlantic Coast Line Case[26] lies in the fact that the dividend paying corporation in this case was a foreign corporation, whereas in the Atlantic Coast Line case the dividend paying corporation was a Kentucky corporation. In both cases the divident receiving corporation was a foreign corporation. It was held that Kentucky could not tax this income.[27]

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[23] Commonwealth v. Radio Corporation of America, 229 Ky. 44, 184 S.W 2d. 250 (1944).

[24] *Supra* note 22.

[25] Atlantic Coast Line Railroad v. Commonwealth, 302 Ky. 36, 193 S.W 2d. 749 (1946).

[26] *Supra* note 25.

[27] Virginia-Carolina Chemical Company v. Commonwealth, 302 Ky. 173, 194 S.W 2d. 180 (1946).

The T Company, a Tennessee corporation with its principal place of business in Texas, owned and operated gas pipe lines extending from Texas through intervening states into Kentucky and ending in West Virginia. The T Company delivered gas in Kentucky to four gas distributing companies, the latter four companies in turn selling at retail to consumers. The deliveries in Kentucky constituted approximately six percent of the T Company s total deliveries of gas. All of the four contracts pertaining to the deliveries of gas in Kentucky were negotiated outside of Kentucky, were signed by the T Company outside of Kentucky, and all but one of the contracts were signed by the distributing companies in Kentucky. Kentucky sought to impose its income tax on the income derived by the T Company from the deliveries made in Kentucky, contending that these deliveries constituted Kentucky sales or receipts within the meaning of Section 141.120 (3) (e) of the statutes. It was held that Kentucky could tax this income, the Court stating that the T Company was doing business in Kentucky. The Court distinguished this case from the R.C.A.,[28] the Atlantic Coast Line[29] and the Fourth Avenue cases.[30] The Court said there should be more emphasis on the transactions giving rise to the receipts — the place of delivery and the place of transfer of title. The Court also said that while the contracts which resulted in the deliveries in Kentucky were negotiated outside of Kentucky, *that it is not the place of contract negotiation which controls*[31]— it is the place of sale, the source of the receipts, and that therefore the facts in this case constituted doing business in Kentucky. Emphasis was placed upon the fact that delivery of tangible property occurred in Kentucky, and that title to such property remained in the T Company until such delivery.[32]

Now that the Kentucky Legislature has by statute made the place of "chief negotiation" the sole criterion for purposes of allocation of receipts,[33] the Tennessee Gas case[34] is important only on the question of how the Kentucky Court may interpret the "chief

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[28] *Supra* note 23.
[29] *Supra* note 25.
[30] *Supra* note 22.
[31] Emphasis mine.
[32] Tennessee Gas Company v. Commonwealth, 308 Ky. 571, 215 S.W 2d. 102 (1948).
[33] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (3) (f).
[34] *Supra* note 32.

negotiation" phrase in the statute. The inclination shown by the Court in the Tennessee Gas case[35] to under-emphasize the importance of the place of chief negotiation, now that the Court in future cases will be confronted with a statute making the place of chief negotiation the sole determinant, poses the question of whether the Court will indulge in judicial legislation for the purpose of continuing to under-emphasize this factor in order to perpetuate the doctrine of the Tennessee Gas case. At the time of the Tennessee Gas decision, the statute then in effect made the place of chief negotiation an equal factor with the place of execution. Of the six cases, the Tennessee Gas case is the only one dealing with the allocation of actual operating income, as distinguished from income from investments. It would thus appear that the Tennessee Gas case is the only decision dealing with the statutory concept of "business income" However, the language used by the Court in the Fourth Avenue case[36] indicates that the Court considered the income in that case as "business income" even though it was derived from dividends; and in fact, the Court in the Atlantic Coast Line case[37] has this to say of the Fourth Avenue case,[38] " we regarded the dividends as 'business income' " [39]

As a result of a change made in the law in 1950, if the business of a corporation is carried on partly within and partly without the State of Kentucky, in order to use separate accounting for the purpose of determining the net income received from business in Kentucky, the corporation must obtain permission from the Kentucky Department of Revenue prior to filing its tax return.[40] It would appear that a determination of whether or not permission for separate accounting would be granted could be made by the Department of Revenue prior to the election of an incoming industry to operate in Kentucky at all. Applications for permission to change from the statutory formula to separate accounting or vice versa must be made within ninety days after the beginning of the taxable year.[41]

In connection with the problem of separate accounting, the

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[35] *Ibid.*
[36] *Supra* note 22.
[37] *Supra* note 25.
[38] *Supra* note 22.
[39] *Ibid* at page 756.
[40] 1950 Legislative Supplement to the Kentucky Revised Statutes, Section 141.120 (2).
[41] Income Tax Law and Regulations 1948, Page 33, Article 120-2.

writer is reliably informed that the Kentucky taxing authority now contemplates *requiring* foreign corporations to file a consolidated return. There is some doubt, in the writer s opinion, as to whether or not a consolidated return could be required under present law; and there is reason to believe that such could not be required without additional legislation. However, if a consolidated return is required, the necessity of separate accounting would probably be eliminated. At the present time a consolidated return is not required.

A somewhat similar problem grows out of the application of the Kentucky corporation license tax.[42] This tax is imposed annually upon both foreign and domestic corporations at the rate of seventy cents per one thousand dollars of that part of the value of the corporation s capital stock represented by property owned and business transacted in Kentucky.

Pursuant to this tax law, a corporation has the option to pay upon the entire value of its capital stock, and thus to avoid calculating that proportion of the value of its capital stock represented by property owned and business transacted in Kentucky.[43] The regulation promulgated by the Department of Revenue in administering this tax[44] provides for the use of a single factor formula-market value, in connection with corporations whose capital stock is listed with recognized exchanges. This regulation also provides that, if market value may not be determined, a two factor formula will be used: average annual income and capitalization of net income. The result obtained by use of this two factor formula is then adjusted in accordance with net worth.

A previous regulation provided for a three factor formula in all cases: market value of capital stock, capitalized earnings and net worth. The use of this previous formula resulted in litigation wherein the Court held that the Kentucky taxing authority had no right to use the capitalized earnings factor.[45] As a result of this decision, the Kentucky Department of Revenue changed its administration of this tax, so as to use the factor of capitalized earnings only in cases where market value of capital stock may not be determined.

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[42] Kentucky Revised Statutes (1948), Sections 136.080-136.110, inclusive.
[43] Kentucky Revised Statutes (1948), Section 136.070 (2).
[44] Regulation CO-4.
[45] Kentucky State Tax Commission v. Tube Turns, Inc., 283 Ky. 474, 141 S.W 2d. 875 (1940).