

NEXUS

UNDERSTANDING & APPLICATION



CT 300
April 2010
Communications & Training Branch

NEXUS

Understanding & Application

Contents

Introduction to Nexus	2
Public Law 86-272.....	4
Independent Contractors	11
Pre-2005 Nexus Rules.....	12
Examples of Nexus Pre-2005	16
2005 and 2006 Nexus Rules	17
Change to Corporate Income Nexus Tax Standard.....	19
Mandatory Nexus	23
Elective Consolidated Returns	23
Helpful Hints.....	33
Examples of Nexus for 2005 and 2006	34
2007 Nexus Rules.....	39
Mandatory Nexus Requirements of Affiliated Groups	43
Practitioner’s Scenarios.....	44
Nexus Questionnaire.....	45

INTRODUCTION TO NEXUS

The term “nexus” refers to the level of activity or presence that a taxpayer has established within a taxing jurisdiction. It is standard procedure to determine if Kentucky has jurisdiction/nexus over the corporate entity and therefore subject such entity to taxation under KRS Chapter 141 for income tax purposes. Jurisdiction-to-tax rules establish the criteria for determining whether a multistate or multinational corporation is engaged in sufficient activities or has sufficient connections within a state to render it subject to that state’s income tax. These rules are an outgrowth of the commerce and due process clause requirements of the U.S. Constitution that a state’s income tax be imposed only on activities that have a certain minimum connection, or nexus, within the state.

The Due Process Clause of the Fourteenth Amendment requires some minimum connection between a taxing district and the person, property or transaction it seeks to tax. The most minimal connection will satisfy this requirement. The connection need not include physical presence in the taxing district. Due Process also requires that the income attributed to the taxing district for tax purposes must rationally relate to values connected with the taxing district. This last requirement is rarely a bar to enforcement of tax.

The Commerce Clause of the Constitution (Article 1, Section 8, C13) gives to Congress the power to regulate commerce among the states. Therefore, a state (or taxing districts) may not impermissibly affect interstate commerce without congressional authorization.

The U.S. Supreme Court held in Complete Auto Transit (430 US 274 (1976)) that a state does not impermissibly affect interstate commerce if it meets each of four tests:

1. The taxed activity has a substantial nexus to the taxing state.
2. The tax is fairly apportioned among states.
3. The tax does not discriminate against interstate commerce.
4. The tax is fairly related to services provided by the taxing state.

The area of greatest confusion in this four-part test is what constitutes “substantial nexus” for the purpose of the Complete Auto test.

A corporation’s legal domicile (the state in which it is incorporated) has jurisdiction to tax the corporation, even if the contacts of the corporation with the state are extremely limited. The “nexus” problem arises in applying the jurisdiction-to-tax rules to out-of-state corporations engaged in activities in more than one state.

It is imperative to determine the full extent of a multi-state corporation’s activity in Kentucky. Once nexus is established by a taxpayer during a tax year for income tax purposes, nexus shall exist for that taxpayer for at least that entire tax year.

In addition to the limitations imposed by the Due Process and Commerce Clause, the Congress of the United States created an additional protection from nexus for certain potential taxpayers. Public Law 86-272 prohibits a state from imposing any tax on a company measured by net income that is derived "from interstate commerce if the only business activities within the state by or on behalf of the company are the minimum activities described in the bill". The minimum activities are that the company must limit its activities in the state to the mere "solicitation" of sales of "tangible personal property." Also, all of the company's orders must be sent outside the state for approval or rejection and, if approved, the order must be filled by a "delivery" from a location outside the state. Public Law 86-272 will be discussed in the material that follows.

PUBLIC LAW 86-272 AND ITS IMPACT ON NEXUS

IMPACT ON NEXUS

An additional step that must be considered is whether the entity is exempt under Public Law 86-272. When a corporation is immune from state taxation under P.L. 86-272, nexus is basically a moot point. Nexus is not present where a state is prohibited from imposing its tax because the corporation's activities do not exceed the standard of mere solicitation of sales established by Public Law 86-272. However, 103 KAR 16:240 adopts a narrow interpretation of the immunity afforded by Public Law 86-272.

Public Law 86-272 provides in pertinent part:

No state, or political subdivision thereof, shall have power to impose, . . . a net income tax on the income derived within such state by any person from intrastate commerce if the only business activities within such state by or on behalf of such a person during the taxable year are either, or both, of the following...

1. The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside of the state; ... and
2. The solicitation of orders by such a person, or his representative, in such State in the name of or for the benefit of a prospective customer of such a person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph 1.

States are thus prevented under Public Law 86-272 from taxing out-of-state corporations on income derived from business activities within the state if their activities are limited to "mere solicitation of orders" for the sale of tangible personal property and the orders are approved and filled from outside the state.

**UNPROTECTED AND PROTECTED
ACTIVITIES UNDER PL 86-272**

Only the solicitation to sell **tangible personal property** is afforded immunity under P.L. 86-272; therefore, the **leasing, renting, licensing or other disposition** of tangible personal property, or transactions involving intangibles, such as franchises, patents, copyrights, trademarks, service marks, and the like, or any other type of property are not protected activities under P.L. 86-272. The sale or delivery and the solicitation for the sale or delivery of any type of service that is not either (1) ancillary to solicitation or (2) otherwise set forth as a protected activity is also not protected under P.L. 86-272 or this ruling.

For the in-state activity to be a protected activity under P.L. 86-272, it must be limited solely to solicitation. Solicitation means (1) speech or conduct that explicitly or implicitly invites an order; and, (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary (secondary or of lesser importance) to requests for an order. Ancillary activities are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities that a seller would engage in apart from soliciting orders shall not be considered as ancillary to the solicitation of orders. The mere assignment of activities to sales personnel does not, merely by such assignment, make such activities ancillary to solicitation of orders. Additionally, activities that seek to promote sales are not ancillary because P.L. 86-272 does not protect activity that facilitates sales; it only protects ancillary activities that facilitate the request for an order. The conducting of activities not falling within the foregoing definition of solicitation will cause the company to lose its protection from a net income tax afforded by P.L. 86-272, unless the disqualifying activities, taken together, are either de minimis or are otherwise permitted by this ruling.

De minimis activities are those that, when taken together, establish only a trivial connection with the taxing state. An activity conducted within a taxing state on a regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) shall normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the state is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a nontrivial connection with the taxing state, then such activity exceeds the protection of P.L. 86-272. Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing state is not determinative of whether a de minimis level of activity exists. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the taxing state is inconsistent with the limited protection afforded by P.L. 86-272.

UNPROTECTED ACTIVITIES

The following in-state activities (assuming they are not of a de minimis level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under P.L. 86-272.

1. Making repairs or providing maintenance or service to the property sold or to be sold.
2. Collection of current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.
3. Investigating credit worthiness.
4. Installation or supervision of installation at or after shipment or delivery.
5. Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation of sales of tangible personal property.
6. Providing any kind of technical assistance or service including, but not limited to, engineering assistance or design service, when one of the purposes thereof is other than the facilitation of the solicitation of orders.
7. Investigating, handling, or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
8. Approving or accepting orders.
9. Repossessing property.
10. Securing deposits on sales.
11. Picking up or replacing damaged or returned property.
12. Hiring, training, or supervising personnel, other than personnel involved only in solicitation.
13. Using agency stock checks or any other instrument or process by which sales are made within this state by sales personnel.
14. Maintaining a sample or display room in excess of two weeks (14 days) at any one location within the state during the tax year.
15. Carrying samples for sale, exchange or distribution in any manner for consideration or other value.

16. Owning, leasing, using, or maintaining any of the following facilities or property in-state:
 - a. Repair shop.
 - b. Parts department.
 - c. Any kind of office other than an in-home office.
 - d. Warehouse.
 - e. Meeting place for directors, officers, or employees.
 - f. Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
 - g. Telephone answering service that is publicly attributed to the company or to employees or agent(s) of the company in their representative status.
 - h. Mobile stores, i.e., vehicles with drivers who are sales personnel making sales from the vehicles.
 - i. Real property or fixtures to real property of any kind.
17. Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.
18. Maintaining by any employee or other representative, an office or place of business of any kind (other than an in-home office located within the residence of the employee or representative that (i) is not publicly attributed to the company or to the employee or representative of the company in an employee or representative capacity, and (ii) so long as the use of such office is limited to soliciting and receiving orders from customers, for transmitting such orders outside the state for acceptance or rejection by the company, or for such other activities that are protected under P.L. 86-272).
19. A telephone listing or other public listing within the state for the company or for an employee or representative of the company in such capacity or other indications through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state shall normally be determined as the company maintaining within this state an office or place of business attributable to the company or to its employee or representative in a representative capacity. However, the normal distribution and use of business cards and stationery identifying the employee's or representative's name, address, telephone and fax numbers, and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative. The maintenance of any office or other place of business in this state that does not strictly qualify as an "in-home" office as described above shall, by itself, cause the loss of protection under this ruling. For the purpose of this subsection it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining such in-home office.
20. Entering into franchising or licensing agreements, selling or otherwise disposing of franchises and licenses, or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchiser or licensor to its franchisee or licensee within the state.

21. Conducting any activity not listed in Protected Activities which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.
22. Providing shipping information and coordinating deliveries.
23. Supervising the operations of a franchisee or similar party.
24. Monitoring, inspecting, or approving work performed by an independent contractor under a warranty or similar contractual arrangement.

PROTECTED ACTIVITIES

The following in-state activities will not cause the loss of protection for otherwise protected sales:

1. Soliciting orders for sales by any type of advertising.
2. Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office as described in paragraph 18 above.
3. Carrying samples and promotional materials only for display or distribution without charge or other consideration.
4. Furnishing or setting up display racks and advising customers on the display of the company's products without charge or other consideration.
5. Providing automobiles to sales personnel for their use in conducting protected activities.
6. Passing orders, inquiries, and complaints on to the home office.
7. Missionary sales activities; i.e., the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune.
8. Coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order. Checking of customers' inventories without a charge for same (for re-order, but not from other purposes such as quality control). Maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year. Recruiting, training, or evaluating sales personnel, including occasionally using homes, hotels, or similar places for meetings with sales personnel. Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders. Owning, leasing, using, or maintaining personal property for use in the employee's or representative's "in-home" office or automobile that is solely limited to the conducting of protected activities. Therefore, the use of personal property such as a cellular telephone, facsimile machine, duplicating equipment, personal computer, and computer software that is limited to the carrying on of protected solicitation and activity entirely ancillary to such solicitation or permitted by this ruling shall not, by itself, remove the protection under this ruling.

INDEPENDENT CONTRACTORS

P.L. 86-272 provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the company or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without the company's loss of immunity:

1. Soliciting sales
2. Making sales
3. Maintaining an office

Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those provided under P.L. 86-272 and this ruling.

Maintenance of a stock of goods in the state by the independent contractor under consignment or any other type of arrangement with the company except for purposes of display and solicitation is not a protected activity.

The protection afforded by P.L. 86-272 and the provisions of this ruling do not apply to any corporation incorporated within this state or to any person who is a resident of or domiciled in this state.

PRE-2005 NEXUS RULES

PRE-2005 NEXUS RULES

Corporations subject to Kentucky income tax per **KRS 141.040(1)** include the following:

Every corporation organized under the laws of this state, every corporation having its commercial domicile as defined in **KRS 141.120(1)(b)** in this state, and every foreign corporation owning or leasing property located in this state or having one (1) or more individuals receiving compensation as defined in **KRS 141.120(8)(b)** in this state...shall pay for each taxable year a tax to be computed by the taxpayer on taxable net income at the rates specified in subsections (2), (3), and (4) of this section.

For tax periods prior to 1/1/2005, corporations having property and payroll only in this state were taxed 100%. Apportionment pre-2005 will only apply to corporations having property or payroll both within and without this state. **KRS 141.010(14)(a) and (b)**.

KRS 141.120(1)(b) defines "commercial domicile" as the principal place from which the trade or business of the corporation is managed.

KRS 141.040(1) establishes taxing jurisdiction (nexus) for foreign corporations owning or leasing property in this state. The statute uses the term property, which includes tangible as well as intangible. Accordingly, property does not have to be tangible to satisfy **KRS 141.040(1)** requirements. For example, a corporation like Quality Inns, an entity based outside Kentucky, only has franchisee operations in Kentucky. The franchisor (Quality Inns) does not have any employees or tangible property in Kentucky. However, they do have franchisee operations. It is the DOR's position that the franchise agreement (intangible property) is said to have acquired a business situs in Kentucky, i.e., franchisee is physically located in Kentucky, thus the franchisor has property in this state. The activities of the franchisor through the operations of the franchisee establish nexus. This would include, but not necessarily be limited to, the holding of in-state management training.

Corporations doing business in Kentucky solely as a partner in a partnership PRE-2005

If during the taxable period a corporation was not organized under the laws of Kentucky, was not commercially domiciled in Kentucky, and neither owned nor leased tangible property nor had employees in Kentucky, but was a partner in a partnership doing business in Kentucky, the corporation is subject to Kentucky income tax on its distributive share of income passed through the partnership pursuant to **KRS 141.206**.

In a related matter, if the only activity of the corporation in Kentucky is by virtue of being a corporate partner in a Kentucky partnership or a partnership doing business within/without Kentucky, the corporate partner would not be subject to license tax because such corporate partner would not have property or payroll in Kentucky, thus not meeting the requirements of **KRS 136.070(1)**. In contrast to income tax, **KRS 141.206** does not extend to license tax.

KRS 141.206 addresses apportionment issues for pass-through entities and was amended in 2002 to read as follows:

(1) Every partnership or S corporation owning property or engaging in business in Kentucky, shall, on or before the fifteenth day of the fourth month following the close of its annual accounting period, file a copy of its federal partnership return or S corporation return with the form prescribed and furnished by the cabinet.

(2) Partnerships and S corporations shall determine taxable income in the same manner as in the case of an individual under KRS 141.010(9) to (11) and the adjustment required under Sections 703(a) and 1363(b) of the Internal Revenue Code. Computation of taxable income under this section and the computation of the partners or shareholders distributive share shall be computed as nearly as practicable identical with those required for federal income tax purposes except to the extent required by differences between this chapter and the federal income tax law and regulations.

(3) Individuals or corporations carrying on a business as a partnership or S corporation shall be liable for income tax only in their individual or corporate capacities, and no income tax shall be assessed upon the income of any partnership or S corporation except as prescribed in KRS 141.040(5).

- (a) Resident and nonresident individuals who are partners or S corporation shareholders must report and pay tax on the distributive share of net income, gain, loss, deduction, or credit, as determined in subsection (2) of this section, except as provided in subsections (4) and (5) of this section. Partnerships and S corporations may be required to withhold Kentucky income tax on the distributive share under administrative regulations issued by the cabinet.
- (b) Corporations which are partners must include their distributive share of net income, gain, loss, deduction or credit, as determined under subsection (2) of this section, except as provided in subsections (4) and (5) of this section. Resident and nonresident individuals and corporations which are partners in a partnership or shareholders in an S corporation carrying on business only in Kentucky are taxable on all items of income gain, loss, deduction or credit determined under subsection (2) of this section and reported as their distributive share from the partnership or S corporation.

(4) Nonresident individuals and corporations which are partners in a partnership or shareholders in an S corporation which does business within and without Kentucky are taxable on their proportionate share of the distributive income passed through the partnership or S corporation attributable to business done in Kentucky.

- (a) Business done in Kentucky is determined by the ratio of gross receipts from sales to purchasers or customers in Kentucky or services performed in Kentucky to the total gross receipts from sales or service everywhere.

(5) Resident partners, S corporation shareholders and corporations who are partners in a multistate partnership or shareholders in a multistate S corporation are taxable on one hundred percent (100%) of the distributive share of income, gains, losses, deductions or credits.

(6) Resident individuals who are partners in a partnership or shareholders in an S corporation which does not carry on business in Kentucky are subject to tax under **KRS 141.020** on federal net income, gain, deduction, loss or credit passed through the partnership or S corporation.

(7) S corporation for purpose of this section means a corporation which has elected for federal tax purposes to be taxed as an S corporation. An election for federal tax purposes is a binding election for Kentucky tax purposes.

(8) Nonresident individuals shall not be taxable on investment income distributed by a qualified investment partnership. For purposes of this subsection a "qualified investment partnership" means a partnership formed to hold only investments that produce income that would not be taxable to the nonresident individual if held or owned individually.

EXAMPLES OF NEXUS PRE-2005

1. Corporation X that is based in Ohio has a plant in Corbin. Since the Company has a plant in Kentucky, they have property located here as well as employees, thus satisfying the requirements of **KRS 141.040(1)**. In that the corporation has a plant here, they are obviously engaged in activity that exceeds mere solicitation. Accordingly, their activity in Kentucky is more than mere solicitation and this taxpayer cannot claim immunity afforded under PL 86-272.

It should be noted that Corporation X also has property and payroll in other states; consequently, they are considered multi-state. An audit disclosed that in some of these other states, the activity was limited to a salesperson operating out of his/her home. In this salesperson's home was a company-owned file cabinet, a desk and a calculator. This person did not have a company name over the door, did not advertise in the Yellow Pages and did not hold his/her home out to be a sales office. Therefore, the taxpayer felt that the company was exempt in those states because of PL 86-272. This was a fair defense because the sales people were not doing anything other than mere solicitation.

2. A Kentucky-domiciled corporation has no property or payroll in Kentucky or elsewhere. Its only source of income is through being a partner in a limited partnership that is domiciled outside Kentucky but has property and payroll in Kentucky. The corporate partner's income would be taxable 100% in Kentucky because the corporation's legal domicile is in Kentucky.

Issue: Whether a foreign corporation, whose activity in Kentucky is limited to franchisee operations, is subject to Kentucky taxation.

DOR's Position: This type of activity would subject the foreign corporation to taxation. **KRS 141.040(1)** says in part: "...every foreign corporation owning or leasing property in this state...should pay for each taxable year a tax to be computed by the taxpayer on taxable net income...." The word "property," as reflected in the statute, is interpreted to include all property, whether tangible or intangible. If the franchisee is located in Kentucky, then the franchise (intangible) is said to have acquired a business situs in Kentucky. Thus, the franchisor has property in the state.

Note: A corporation incorporated outside Kentucky but having all its property and payroll in Kentucky does not qualify for multistate status.

2005 AND 2006 NEXUS RULES

2005 AND 2006 NEXUS RULES

House Bill 272 greatly revised how pass-through entities were taxed in Kentucky in 2005 and 2006. Multi-member limited liability companies, single-member limited liability companies, limited partnerships, limited liability partnerships and S corporations that were doing business in Kentucky were subject to Kentucky's corporation income tax for tax periods beginning on or after January 1, 2005 through December 31, 2006. House Bill 272 amended the definition of "corporations" in KRS 141.010(24) to include the following entities:

- (a) "Corporations" as defined in Section 7701(a)(3) of the Internal Revenue Code;
- (b) S corporations as defined in Section 1361(a) of the Internal Revenue Code;
- (c) A foreign limited liability company as defined in KRS 275.015(6);
- (d) A limited liability company as defined in KRS 275.015(8);
- (e) A professional limited liability company as defined in KRS 275.01(19);
- (f) A foreign limited partnership as defined in KRS 362.401(4);
- (g) A limited partnership as defined in KRS 362.401(7);
- (h) A registered limited liability partnership as defined in KRS 362.155(7);
- (i) A real estate investment trust as defined in Section 856 of the Internal Revenue Code;
- (j) A regulated investment company as defined in Section 851 of the Internal Revenue Code;
- (k) A real estate mortgage investment conduit as defined in Section 860D of the Internal Revenue Code;
- (l) A financial asset securitization investment trust as defined in Section 860L of the Internal Revenue Code;
- (m) Other similar entities created with limited liability for their partners, members, or shareholders.

Single member limited liability companies meet the above definition of "corporations." General partnerships are not "corporations" and therefore do not pay corporation income tax. Form 765-GP was developed for exclusive use by general partnerships. The "doing business" nexus standard determines whether or not a general partnership has a filing responsibility in Kentucky under the provisions of KRS 141.206. Administrative regulation 103 KAR 16:240 further explains the nexus standard for corporations and general partnerships. While it was not in effect until August 7, 2006, it was made retroactive to apply to taxable years beginning on or after January 1, 2005.

Publicly traded partnerships and their publicly traded partnership affiliates are not considered to be "corporations" under the provisions of **KRS 141.010(24)** and are not subject to the corporation income tax if the publicly traded partnership is treated as a partnership for federal income tax purposes. Publicly traded partnerships meeting this definition are treated as general partnerships for Kentucky income tax purposes.

"Corporations" as defined in **KRS 141.010(24)** are subject to corporation income tax under the provisions of **KRS 141.040(1)**, which imposes the tax on every corporation doing business in this state except for:

- (a) Financial institutions, as defined in **KRS 136.500** (state and national banks), except bankers banks organized under **KRS 287.135**;
- (b) Savings and loan associations organized under the laws of this state and under the laws of the United States and making loans to members only;
- (c) Banks for cooperatives;
- (d) Production credit associations;
- (e) Insurance companies;
- (f) Corporations or other entities exempt under Section 501 of the Internal Revenue Code;
- (g) Religious, educational, charitable, or like corporations not organized or conducted for pecuniary profit; and
- (h) Corporations whose only owned or leased property located in this state is located at the premises of a printer with which it has contracted for printing.

CHANGE TO CORPORATION INCOME TAX NEXUS STANDARD

Corporations that are "doing business" in this state are subject to Kentucky's corporation income tax unless the corporation is specifically exempted from the tax by **KRS 141.040(1)**. "Doing business" is the new corporation income tax nexus standard enacted by House Bill 272 that is a broader nexus standard than the one in effect under **KRS 141.040** for tax periods that began before January 1, 2005. Nexus is the minimal amount of business activity that must be present in order for a state to impose a tax. Prior to House Bill 272, Kentucky's nexus standard for corporation income tax was referred to as a "physical presence" nexus standard of property and payroll.

Under the old nexus standard of property and payroll, Kentucky's corporation income tax applies to any corporation:

- Organized under the laws of Kentucky.
- Having its commercial domicile in Kentucky.

- Owning or leasing property located in Kentucky.
- Having one or more employees in Kentucky.

Changing the Kentucky nexus standard to a “doing business” standard eliminated the competitive advantage that foreign corporations that conduct business in Kentucky and derive income without investing in property or creating jobs in Kentucky have over corporations that do invest in property in Kentucky and create jobs in Kentucky, and is consistent with the nexus standard in **KRS 141.206**.

At the time of the change in nexus standard in 2005, each of the states surrounding Kentucky had either a “doing business” standard or a “deriving income” standard, or a combination of the two. In fact, 46 of the 47 states that impose a corporation income tax were using either a “doing business” nexus standard or a “deriving income” nexus standard, or a combination of both. Kentucky was the only state that utilized the “physical presence” standard.

2005 Nexus Standard per KRS 141.010(25)

In 2005, “doing business” is defined under **KRS 141.010(25)** to include but not be limited to:

- (a) Being organized under the laws of this state;
- (b) Having a commercial domicile in this state;
- (c) Owning or leasing property in this state;
- (d) Having one or more individuals performing services in this state;
- (e) Maintaining an interest in a general partnership doing business in this state;
- (f) Deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state; or
- (g) Directing activities at Kentucky customers for the purpose of selling them goods or services.

2006 Nexus Standard per KRS 141.010(25)

In 2006, "doing business" under KRS 141.010(25) is expanded to include but not be limited to:

- (a) Being organized under the laws of this state;
- (b) Having a commercial domicile in this state;
- (c) Owning or leasing property in this state;
- (d) Having one or more individuals performing services in this state;
- (e) Maintaining an interest in a general partnership doing business in this state;
- (f) Deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state, or deriving income directly or indirectly from a single member limited liability company that is doing business in this state and is disregarded as an entity separate from its single member for federal income tax purposes; or
- (g) Directing activities at Kentucky customers for the purpose of selling them goods or services.

Regulation for further clarification of KRS 141.010(25)

"Doing business" is further explained in 103 KAR 16:240. This regulation defines terminology and also sets forth protected and unprotected activities under PL 86-272. Important highlights to note from the regulation are:

1. "Doing business" does not include an activity that is protected or exempt from state income taxation under the provisions of the United States Constitution or Public Law 86-272. Public Law 86-272 prohibits a state from imposing its income tax on a foreign corporation whose only activity in the state is the solicitation of sales of tangible personal property if the sales orders are approved outside the state and are filled by shipment or delivery from a point outside of Kentucky.
2. "Deriving income" includes performing services in Kentucky, whether directly by the corporation or indirectly by directing activity performed by a third party.
3. "Doing business" includes being the single member of a single member LLC that is disregarded for federal income tax purposes.
4. "Doing business" includes entering into franchising or licensing agreements and receiving income from franchising or licensing agreements that have acquired a Kentucky business situs.
5. "Doing business" also includes being the parent of a qualified real estate investment trust subsidiary or qualified subchapter S subsidiary that is doing business in Kentucky.

CONSOLIDATED RETURNS

MANDATORY NEXUS

House Bill 272 changed the consolidated corporation income tax return rules. Prior to the law change, corporations subject to the tax filed separate entity returns unless an affiliated group of corporations elected to file a consolidated return for a 96-month period. House Bill 272 preserved the elective consolidated return provisions for certain periods and enacted new mandatory nexus consolidated return provisions. Members of an affiliated group doing business in the state, including the parent entity and all included affiliates, must file a consolidated return, whether or not filing a federal consolidated return. A parent entity that elected to file a consolidated tax return prior to the 2005 tax year is subject to the mandatory consolidated return requirements through the end of the election period. If the parent entity has not established nexus in Kentucky, then each affiliate that has established nexus in Kentucky must file a separate entity return.

ELECTIVE CONSOLIDATED RETURNS

KRS 141.200(2) through (7) permits an affiliated group of corporations to make an election to file a consolidated income tax return for a group of corporations that meet the federal definition of affiliated group as defined in Section 1504(a) of the Internal Revenue Code and related regulations. The election to file a consolidated return for an affiliated group as defined under the federal rules applies for taxable periods ending before January 1, 2005, and election periods beginning prior to January 1, 2005 (KRS 141.200(1)).

An "election period" means a period of 96 consecutive calendar months that:

- (a) Begins prior to January 1, 2005; and,
- (b) Begins with the first day of the first taxable year for which an election to file a consolidated return is made and ending on the last day of the taxable year which includes the 96th consecutive calendar month provided the affiliated group remains in existence in accordance with Treasury Regulation section 1.1502-75(d).

The Department of Revenue will honor existing valid consolidated return elections, including initial elections or re-elections made for calendar or fiscal years beginning prior to January 1, 2005. If the last twelve-month taxable year of a 96-month election period ends on or after December 31, 2005, then the affiliated group will be subject to the nexus consolidated return provisions of KRS 141.200(8) through (14) for future periods.

Question: Can a taxpayer include limited liability companies, limited partnerships or limited liability partnerships in a Kentucky elective consolidated return filed for calendar years ending on or after December 31, 2005?

Answer: No, under the elective consolidated rules, the federal definition of affiliated group in Section 1504(a) of the Internal Revenue Code (IRC) and related regulations limits the affiliated group to the federal definition of "includible corporations" in Section 1504(b) of the IRC. Non-corporate entities cannot be included as part of the elective consolidated affiliated group. Kentucky will recognize a limited liability company that elects to be taxed as a corporation as an

“includible corporation” for an elective consolidated group, provided that the LLC is recognized as a member of the affiliated group under the federal consolidated rules.

**MANDATORY NEXUS
CONSOLIDATED RETURNS**

The nexus consolidated return provisions apply to taxable years beginning on or after January 1, 2005. Excluding those affiliated groups under a valid consolidated return election provided under the provisions of KRS 141.200(1) through (7), all other corporations that are doing business in Kentucky are required by KRS 141.200(10) to file a separate return unless the corporation was, for any part of the taxable year:

- (a) An includible corporation in an affiliated group;
- (b) A common parent corporation doing business in this state;
- (c) A qualified subchapter S subsidiary that is included in the return filed by the Subchapter S parent corporation; or,
- (d) A qualified real estate investment trust subsidiary that is included in the return filed by the real estate investment trust parent.

“Common parent corporation” is defined by KRS 141.200(9)(b) to be the member of an affiliated group that meets the ownership requirement of KRS 141.200(9)(a)1. KRS 141.200(9)(a)1 defines “affiliated group to be “one or more chains of includible corporations connected through stock ownership, membership interest, or partnership interest with a common parent corporation if:

- (a) The common parent owns directly an ownership interest meeting the requirements of subparagraph 2 of this paragraph in at least one other includible corporation; and,
- (b) An ownership interest meeting the requirements of subparagraph 2 of this paragraph in each of the includible corporations, excluding the common parent, is owned directly by one or more of the other corporations.

Subparagraph 2 of KRS 141.200(9)(a) states: “The ownership interest of any corporation meets the requirements of this paragraph if the ownership interest encompasses at least 80% of the voting power of all classes of ownership interest and has a value equal to at least 80% of the total value of all ownership interests.”

“Ownership interest” is defined by KRS 141.200(9)(e) to mean stock, a membership interest in a limited liability company, or a partnership interest in a limited partnership or limited liability partnership.

“Includible corporation” is defined by KRS 141.200(9)(d) to mean any corporation that is doing business in this state except:

1. Corporations exempt from corporation income tax under KRS 141.040(1)(a) to (h);
2. Foreign corporations;
3. Corporations with respect to which an election under Section 936 of the Internal Revenue Code is in effect for the taxable year;
4. Real estate investment trusts as defined in Section 856 of the Internal Revenue Code;
5. Regulated investment companies as defined in Section 851 of the Internal Revenue Code;
6. A domestic international sales company as defined in Section 992(a)(1) of the Internal Revenue Code;
7. An S corporation as defined in Section 1361(a) of the Internal Revenue Code;
8. Any corporation that realizes a net operating loss whose Kentucky property, payroll, and sales factors pursuant to subsection (8) of KRS 141.120 are de minimis; and,
9. Any corporation for which the sum of the property, payroll and sales factors described in subsection (8) of KRS 141.120 is zero.

“Foreign corporation” is defined by KRS 141.200(9)(c) to be a corporation that is organized under the laws of a country other than the United States and is related to a member of an affiliated group through stock ownership.

Chains of includible corporations can be part of an affiliated group. Thus, a multi-tiered group of affiliated corporations that are doing business in Kentucky can file a nexus consolidated return provided:

1. All the includible corporations, including the common parent of the multiple-tiered structure have nexus (doing business) in Kentucky;
2. All the includible corporations except for the common parent corporation are directly owned by 80% or more by one or more of the other includible corporations in the group;
3. The common parent directly owns 80% or more of at least one other of the includible corporations in the group.

If the chain or chains of corporations are broken by a member not having nexus in this state or a member not being directly owned by 80% or more by another member, then it is possible for there to be more than one nexus consolidated group within a group of related corporations.

KRS 141.200 Corporation returns -- Requirement of affiliated groups to file consolidated returns.

- (1) Subsections (2) to (7) of this section shall apply for taxable periods ending before January 1, 2005, and election periods beginning prior to January 1, 2005.
- (2) As used in subsections (2) to (7) of this section, unless the context requires otherwise:
 - (a) "Affiliated group" means affiliated group as defined in Section 1504(a) of the Internal Revenue Code and related regulations;
 - (b) "Consolidated return" means a Kentucky corporation income tax return filed by members of an affiliated group in accordance with this section. The determinations and computations required by this chapter shall be made in accordance with the provisions of Section 1502 of the Internal Revenue Code and related regulations, except as required by differences between this chapter and the Internal Revenue Code. Corporations exempt from taxation under **KRS 141.040** shall not be included in the return;
 - (c) "Separate return" means a Kentucky corporation income tax return in which only the transactions and activities of a single corporation are considered in making all determinations and computations necessary to calculate taxable net income, tax due, and credits allowed in accordance with the provisions of this chapter;
 - (d) "Corporation" means "corporation" as defined in Section 7701(a)(3) of the Internal Revenue Code; and
 - (e) "Election period" means the ninety-six (96) month period provided for in subsection (4)(d) of this section.
- (3) Every corporation doing business in this state, except those exempt from taxation under **KRS 141.040**, shall, for each taxable year, file a separate return unless the corporation was, for any part of the taxable year, a member of an affiliated group electing to file a consolidated return in accordance with subsection (4) of this section.
- (4)
 - (a) An affiliated group, whether or not filing a federal consolidated return, may elect to file a consolidated return which includes all members of the affiliated group.
 - (b) An affiliated group electing to file a consolidated return under paragraph (a) of this subsection shall be treated for all purposes as a single corporation under the provisions of this chapter. All transactions between corporations

included in the consolidated return shall be eliminated in computing net income in accordance with KRS 141.010(13), and in determining the property, payroll, and sales factors in accordance with KRS 141.120. The gross receipts received by a public service company that is a member of an affiliated group shall be excluded from the calculation of the alternative minimum calculation under the provisions of KRS 141.040. For purposes of this paragraph, "public service company" has the same meaning as provided in KRS 136.120.

- (c) Any election made in accordance with paragraph (a) of this subsection shall be made on a form prescribed by the department and shall be submitted to the department on or before the due date of the return including extensions for the first taxable year for which the election is made.
 - (d) Notwithstanding subsections (9) to (15) of this section, any election to file a consolidated return pursuant to paragraph (a) of this subsection shall be binding on both the department and the affiliated group for a period beginning with the first month of the first taxable year for which the election is made and ending with the conclusion of the taxable year in which the ninety-sixth consecutive calendar month expires.
 - (e) For each taxable year for which an affiliated group has made an election in accordance with paragraph (a) of this subsection, the consolidated return shall include all corporations which are members of the affiliated group.
- (5) Each corporation included as part of an affiliated group filing a consolidated return shall be jointly and severally liable for the income tax liability computed on the consolidated return, except that any corporation which was not a member of the affiliated group for the entire taxable year shall be jointly and severally liable only for that portion of the Kentucky consolidated income tax liability attributable to that portion of the year that the corporation was a member of the affiliated group.
 - (6) Every corporation return or report required by this chapter shall be executed by one (1) of the following officers of the corporation: the president, vice president, secretary, treasurer, assistant secretary, assistant treasurer, or chief accounting officer. The Department of Revenue may require a further or supplemental report of further information and data necessary for computation of the tax.
 - (7) In the case of a corporation doing business in this state that carries on transactions with stockholders or with other corporations related by stock ownership, by interlocking directorates, or by some other method, the department shall require information necessary to make possible accurate assessment of the income derived by the corporation from sources within this state. To make possible such assessment, the department may require the corporation to file supplementary returns showing information respecting the business of any or all individuals and corporations related by one (1) or more of these methods to the corporation. The department may require the return to

show in detail the record of transactions between the corporation and any or all other related corporations or individuals.

(8) Subsections (9) to (14) of this section shall apply for taxable years beginning on or after January 1, 2005, unless otherwise provided.

(9) As used in subsections (9) to (14) of this section:

(a) 1. For taxable years beginning after December 31, 2004, and before January 1, 2007, "affiliated group" means one (1) or more chains of includible corporations connected through stock ownership, membership interest, or partnership interest with a common parent corporation which is an includible corporation if:

(a) The common parent owns directly an ownership interest meeting the requirements of subparagraph 2 of this paragraph in at least one (1) other includible corporation;

and

(b) An ownership interest meeting the requirements of subparagraph 2 of this paragraph in each of the includible corporations, excluding the common parent, is owned directly by one (1) or more of the other corporations.

2. The ownership interest of any corporation meets the requirements of this paragraph if the ownership interest encompasses at least eighty percent (80%) of the voting power of all classes of ownership interests and has a value equal to at least eighty percent (80%) of the total value of all ownership interests;

(b) For taxable years beginning after December 31, 2006, "affiliated group" means one (1) or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if:

a. The common parent owns directly stock meeting the requirements of subparagraph 2. of this paragraph in at least one (1) other includible corporation; and

b. Stock meeting the requirements of subparagraph 2 of this paragraph in each of the includible corporations, excluding the common parent, is owned directly by one (1) or more of the other corporations.

2. The stock of any corporation meets the requirements of this paragraph if the stock encompasses at least eighty percent (80%) of the voting power of all classes of stock and has a value equal to at least eighty percent (80%) of the total value of all stock;

- c. "Common parent corporation" means the member of an affiliated group that meets the ownership requirement of paragraph (a)1 or (b)1 of this subsection;
- d. "Foreign corporation" means a corporation that is organized under the laws of a country other than the United States and is related to a member of an affiliated group through stock ownership;
- e. "Includible corporation" means any corporation that is doing business in this state except:
 - 1. Corporations exempt from corporation income tax under **KRS 141.040(1)(a) to (i)**;
 - 2. Foreign corporations;
 - 3. Corporations with respect to which an election under Section 936 of the Internal Revenue Code is in effect for the taxable year;
 - 4. Real estate investment trusts as defined in Section 856 of the Internal Revenue Code;
 - 5. Regulated investment companies as defined in Section 851 of the Internal Revenue Code;
 - 6. A domestic international sales company as defined in Section 992(a)(1) of the Internal Revenue Code;
 - 7. Any corporation that realizes a net operating loss whose Kentucky property, payroll, and sales factors pursuant to **KRS 141.120(8)** are de minimis;
 - 8. Any corporation for which the sum of the property, payroll and sales factors described in **KRS 141.120(8)** is zero; and
 - 9. For taxable years beginning prior to January 1, 2006, and taxable years beginning on or after January 1, 2007, an S corporation as defined in Section 1361(a) of the Internal Revenue Code;
- f. "Ownership interest" means stock, a membership interest in a limited liability company, or a partnership interest in a limited partnership or limited liability partnership;
- g. "Consolidated return" means a Kentucky corporation income tax return filed by members of an affiliated group in accordance with this section. The determinations and computations required by this chapter shall be made in accordance with the provisions of the Internal Revenue Code and related

- regulations, except as required by differences between this chapter and the Internal Revenue Code;
- h. "Separate return" means a Kentucky corporation income tax return in which only the transactions and activities of a single corporation are considered in making all determinations and computations necessary to calculate taxable net income, tax due, and credits allowed in accordance with the provisions of this chapter; and
 - i. "Stock" means stock in a corporation, or a membership interest in a limited liability company that has elected to be treated as a corporation for federal tax purposes.
10. Every corporation doing business in this state except those exempt from taxation under **KRS 141.040(1)(a) to (i)** shall, for each taxable year, file a separate return unless the corporation was, for any part of the taxable year:
- a. An includible corporation in an affiliated group;
 - b. A common parent corporation doing business in this state;
 - c. A qualified subchapter S Subsidiary that is included in the return filed by the Subchapter S parent corporation;
 - d. A qualified real estate investment trust subsidiary that is included in the return filed by the real estate investment trust parent; or
 - e. A disregarded entity that is included in the return filed by its parent entity.
- (11). (a) An affiliated group, whether or not filing a federal consolidated return, shall file a consolidated return which includes all includible corporations.
- (b) An affiliated group required to file a consolidated return under this subsection shall be treated for all purposes as a single corporation under the provisions of this chapter. All transactions between corporations included in the consolidated return shall be eliminated in computing net income in accordance with **KRS 141.010(13)**, and in determining the property, payroll, and sales factors in accordance with **KRS 141.120**. Includible corporations that have incurred a net operating loss shall not deduct an amount that exceeds, in the aggregate, fifty percent (50%) of the income realized by the remaining includible corporations that did not realize a net operating loss. The portion of any net operating loss limited by the application of this subsection shall be available for carryforward in accordance with **KRS 141.011**. The Department of Revenue shall promulgate administrative regulations to establish the manner and extent to which net operating losses attributable to tax periods ending prior to January 1, 2005, may offset income of affiliated groups. The gross receipts received by a public service

- company that is a member of an affiliated group shall be excluded from the calculation of the alternative minimum calculation under KRS 141.040. For purposes of this paragraph, "public service company" has the same meaning as provided in KRS 136.120.
- (12) Each includible corporation included as part of an affiliated group filing a consolidated return shall be jointly and severally liable for the income tax liability computed on the consolidated return, except that any includible corporation which was not a member of the affiliated group for the entire taxable year shall be jointly and severally liable only for that portion of the Kentucky consolidated income tax liability attributable to that portion of the year that the corporation was a member of the affiliated group.
- (13) Every corporation return or report required by this chapter shall be executed by one (1) of the following officers or management of the corporation: the president, vice president, secretary, treasurer, assistant secretary, assistant treasurer, chief accounting officer, manager, member, or partner. The Department of Revenue may require a further or supplemental report of further information and data necessary for computation of the tax.
- (14) In the case of a corporation doing business in this state that carries on transactions with stockholders, members or partners, or with other corporations related by ownership, by interlocking directorates, or by some other method, the department shall require that information necessary to make possible an accurate assessment of the income derived by the corporation from sources within this state be provided. To make possible this assessment, the department may require the corporation to file supplementary returns showing information respecting the business of any or all individuals and corporations related by one (1) or more of these methods to the corporation. The department may require the return to show in detail the record of transactions between the corporation and any or all other related corporations or individuals.
- (15) For any taxable year ending on or after December 31, 1995, except as provided under this section and KRS 141.205, nothing in this chapter shall be construed as allowing or requiring the filing of:
- a. A combined return under the unitary business concept; or
 - b. A consolidated return.
- (16) No assessment of additional tax due for any taxable year ending on or before December 31, 1995, made after December 22, 1994, and based on requiring a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.
- (17) No claim for refund or credit of a tax overpayment for any taxable year ending on or before December, 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business

concept or to a consolidated return, shall be effective or recognized for any purpose.

- (18) No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.
- (19) This section shall not be construed to limit or otherwise impair the department's authority under KRS 141.205.

HELPFUL HINTS

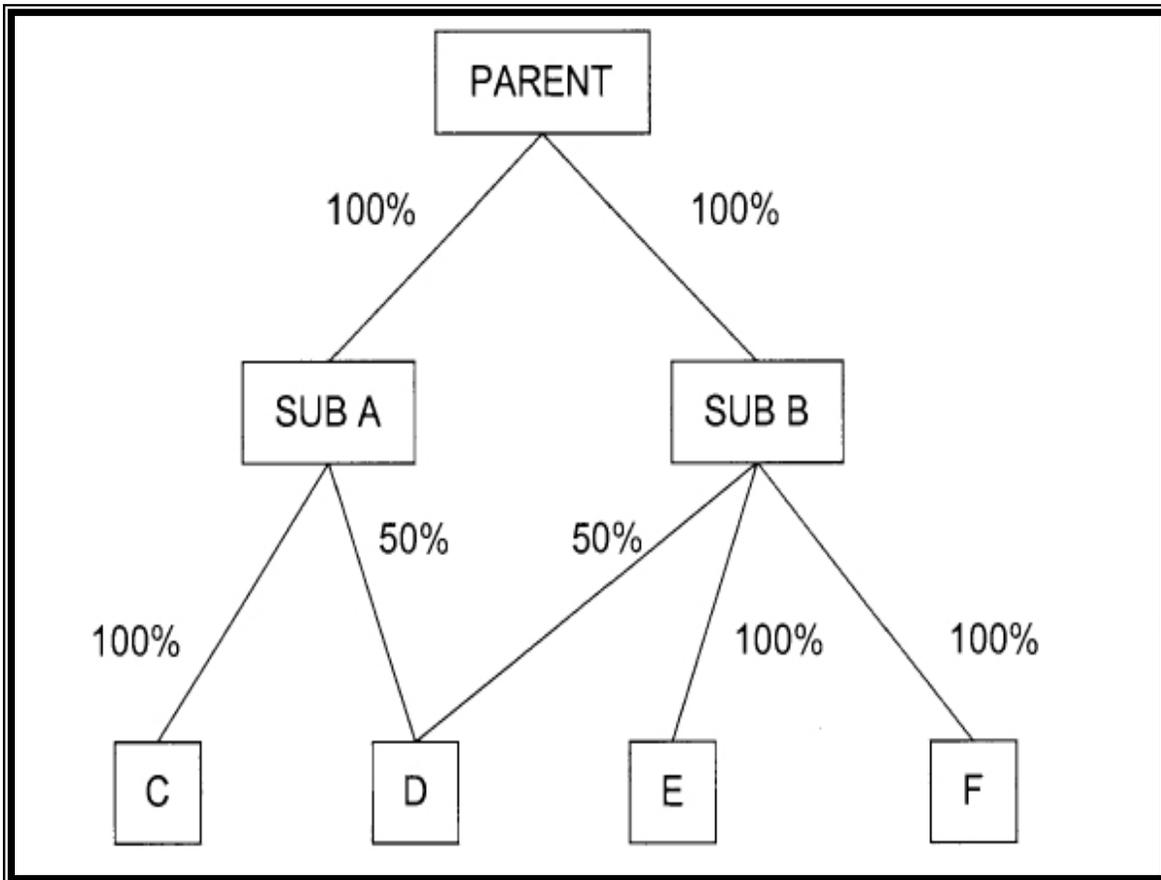
When examining a Form 720 for mandatory nexus adherence, look at the Schedule Q - Kentucky Corporation Questionnaire. Beginning in 2005 and going forward, the questionnaire asks the following questions:

- Did the corporation at any time during the taxable year do business in Kentucky and own 80 percent or more of the voting stock of another corporation doing business in Kentucky?
- Was 80 percent or more of the corporation's voting stock owned by any corporation doing business in Kentucky at any time of the year?

Other questions to consider are whether disregarded entities are included in the return, whether the corporation is a partner in a general partnership doing business in Kentucky, and whether any net distributive income (loss) received from a corporation subject to the tax imposed by **KRS 141.040** (i.e., every corporation doing business in this state, with some exceptions) is included in the return.

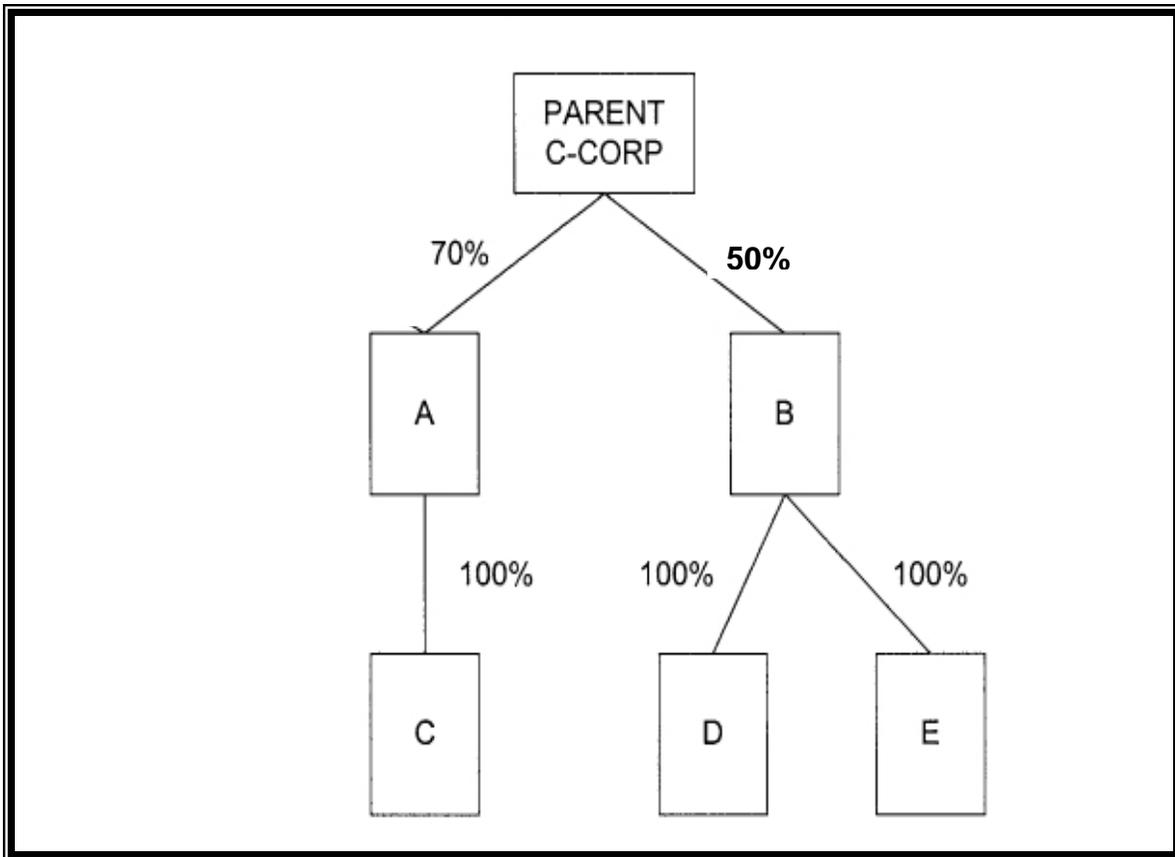
EXAMPLES OF NEXUS FOR 2005 AND 2006

EXAMPLE 1



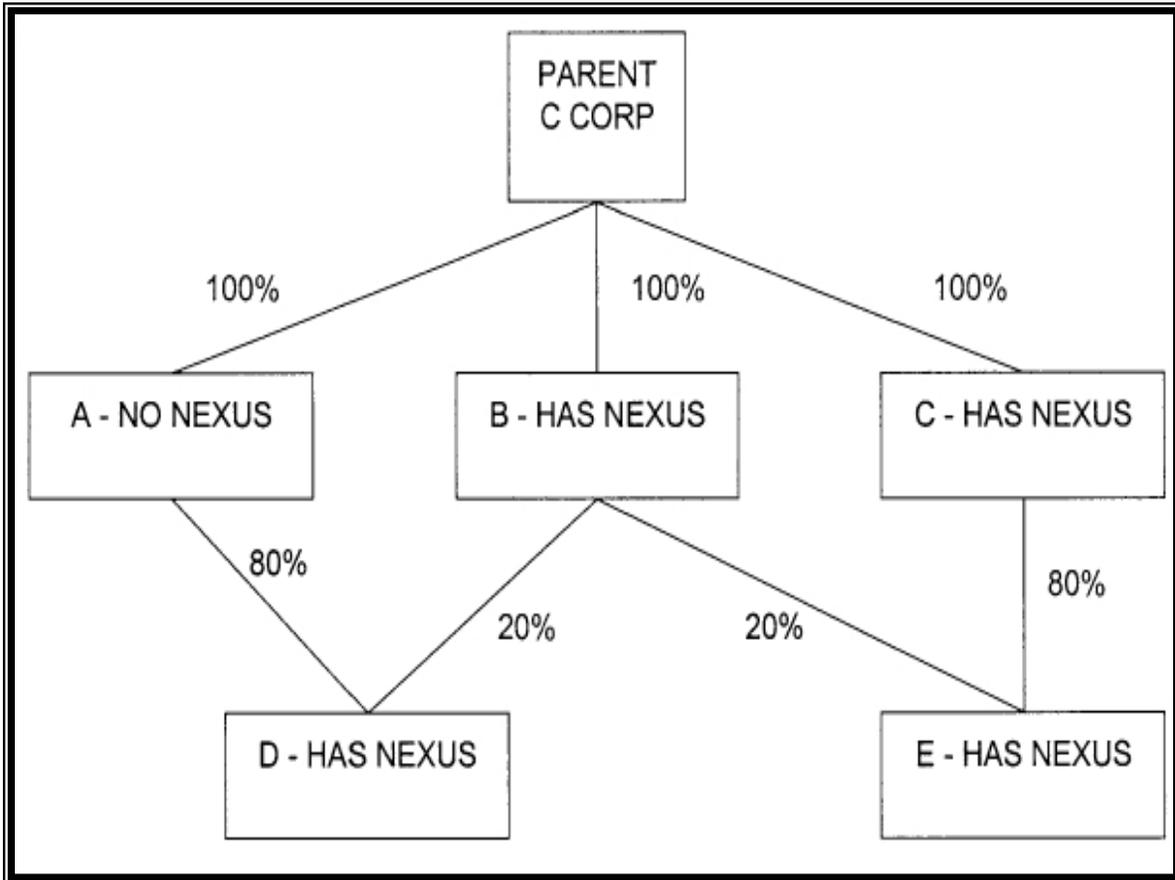
- Parent and all subsidiaries have nexus.
- Parent and all subsidiaries are C-corporations.
- Nexus consolidated return includes Parent, A, B, C, D, E, and F.
- D is included in the consolidated return because D is 80% or more owned by one or more (A & B) of the includible corporations in the affiliated group.

EXAMPLE 2



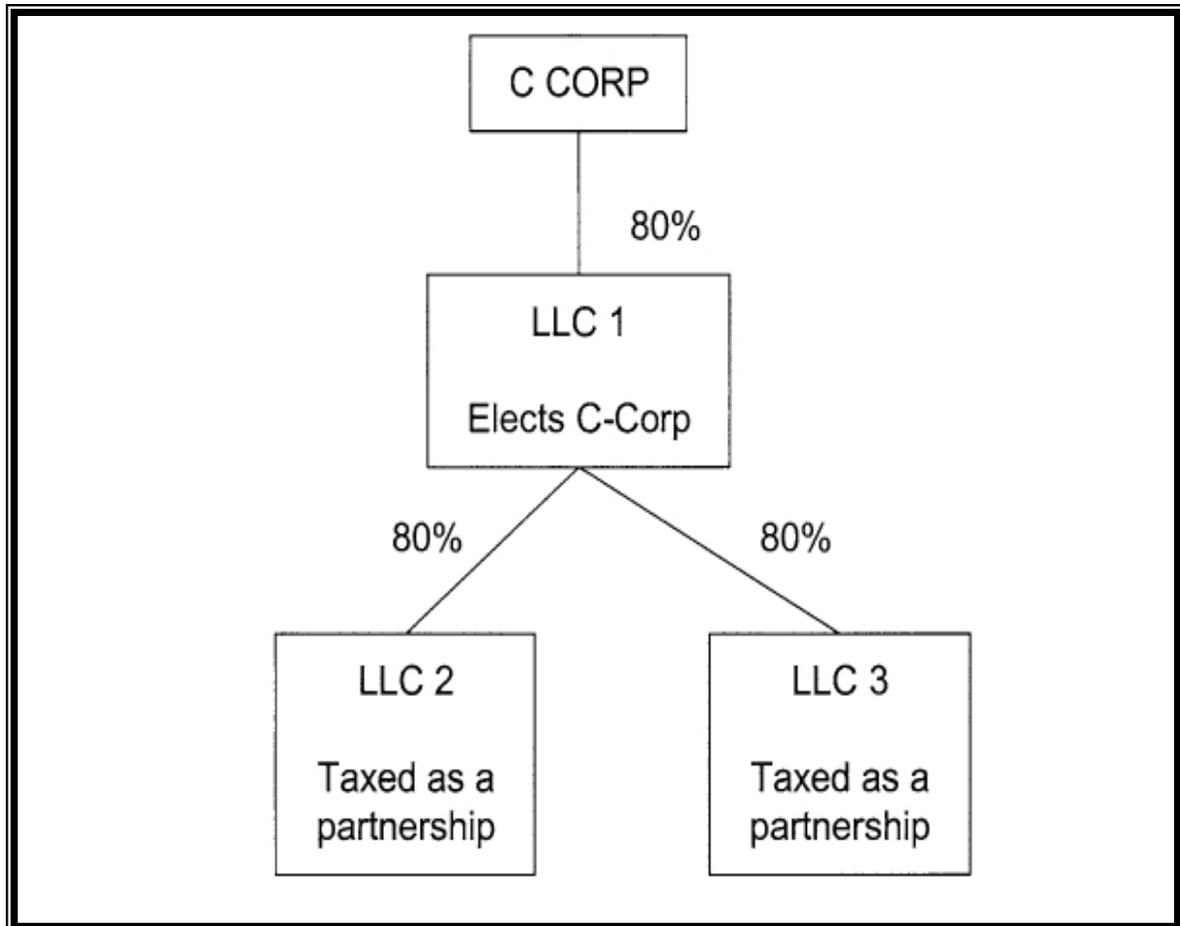
- All are C corporations that have nexus in Kentucky.
- The parent does not own 80% or more of A and B and cannot be included in a nexus consolidated return.
- The parent must file a separate entity return.
- A and C are from one nexus consolidated group, with A being the common parent.
- B will file a nexus consolidated return with D and E.
- B will be the common parent.

EXAMPLE 3



- Parent and all subsidiaries are C corporations.
- Parent, B, C, and E can file a nexus consolidated return.
- D has to file a separate entity return.
- A does not have to file.

EXAMPLE 4



- Assume that C corporation and all LLCs have nexus.
- All entities will be included in a nexus consolidated return.
- Federal tax status of LLC 2 and LLC 3 does not impact their inclusion in a nexus consolidated return.

2007 NEXUS RULES

2007 NEXUS RULES

On June 28, 2006, the Kentucky General Assembly enacted House Bill 1 which restored federal pass-through entity treatment for taxable years beginning on or after January 1, 2007. This meant that all pass-through entities are once again treated the same for Kentucky income tax purposes as they are treated for federal income tax purposes except for differences between Kentucky law and federal law. LLCs, S corporations, limited liability partnerships and limited partnerships are no longer taxed at the entity level under the corporation income tax. The income is passed through and taxed at the ownership level.

KRS 141.206 outlines apportionment issues for pass-through entities and states in part as follows:

(7) A corporation that is subject to tax under **KRS 141.040** and is a partner or member in a pass-through entity shall take into account the corporation's distributive share of the pass-through entity's items of income, loss, and deduction and:

(a) For taxable years beginning prior to January 1, 2007, the items of income, loss, and deduction, when applicable, shall be multiplied by the apportionment fraction of the pass-through entity as prescribed in subsection (9) of this section; or

(b) For taxable years beginning on or after January 1, 2007:

1. A corporation that owns an interest in a limited liability pass-through entity or that owns an interest in a general partnership organized or formed as a general partnership after January 1, 2006, shall include the proportionate share of the sales, property, and payroll of the limited liability pass-through entity or general partnership in computing its own apportionment factor;
2. A corporation that owns an interest in a general partnership organized or formed on or before January 1, 2006, shall follow the provisions of paragraph (a) of this subsection; and

(c) Credits from the partnership.

(8) (a) If a pass-through entity is doing business both within and without this state, the pass-through entity shall compute and furnish to each partner, member, or shareholder the numerator and denominator of each factor of the apportionment fraction determined in accordance with subsection (9) of this section.

(b) For purposes of determining an apportionment fraction under paragraph (a) of this subsection, if the pass-through entity is:

1. Doing business both within and without this state; and

2. A partner or member in another pass-through entity; then the pass-through entity shall be deemed to own the pro rata share of the property owned or leased by the other pass-through entity, and shall also include its pro rata share of the other pass-through entity's payroll and sales.
 - (c) The phrases "a partner or member in another pass-through entity" and "doing business both within and without this state" shall extend to each level of multiple-tiered pass-through entities.
 - (d) The attribution to the pass-through entity of the pro rata share of property, payroll and sales from its role as a partner or member in another pass-through entity will also apply when determining the pass-through entity's ultimate apportionment factor for property, payroll and sales as required under subsection (9) of this section.
- (9) A pass-through entity doing business within and without the state shall compute an apportionment fraction, the numerator of which is the property factor, representing twenty-five percent (25%) of the fraction, plus the payroll factor, representing twenty-five percent (25%) of the fraction, plus the sales factor, representing fifty percent (50%) of the fraction, with each factor determined in the same manner as provided in **KRS 141.120(8)**, and the denominator of which is four (4), reduced by the number of factors, if any, having no denominator, provided that if the sales factor has no denominator, then the denominator shall be reduced by two (2).
- (10) Resident individuals, estates, or trusts that are partners in a partnership, members of a limited liability company electing partnership tax treatment for federal income tax purposes, owners of single member limited liability companies, or shareholders in an S corporation which does not do business in this state are subject to tax under **KRS 141.020** on federal net income, gain, deduction, or loss passed through the partnership, limited liability company, or S corporation.
- (11) An S corporation election made in accordance with Section 1362 of the Internal Revenue Code for federal tax purposes is a binding election for Kentucky tax purposes.
- (12)
 - (a) Nonresident individuals shall not be taxable on investment income distributed by a qualified investment partnership. For purposes of this subsection, a "qualified investment partnership" means a pass-through entity that, during the taxable year, holds only investments that produce income that would not be taxable to a nonresident individual if held or owned individually.
 - (b) A qualified investment partnership shall be subject to all other provisions relating to a pass-through entity under this section and shall not be subject to the tax imposed under **KRS 141.040** or **141.0401**.

- (13) (a) A pass-through entity may file a composite income tax return on behalf of electing nonresident individual partners, members, or shareholders, reporting and paying income tax at the highest marginal rate provided in this chapter on the partners', members', or shareholders' pro rata or distributive shares of income of the pass-through entity from doing business in, or deriving income from sources within, this state. The partners', members', or shareholders' pro rata or distributive share of income shall include all items of income or deduction used to compute adjusted gross income on the Kentucky return that is passed through to the partner, member, or shareholder by the pass-through entity, including but not limited to interest, dividend, capital gains and losses, guaranteed payments, and rents.
- (b) A nonresident individual partner, member, or shareholder whose only source of income within this state is distributive share income from one (1) or more pass-through entities may elect to be included in a composite return filed pursuant to this section.
- (c) A nonresident individual partner, member, or shareholder that has been included in a composite return may file an individual income tax return and shall receive credit for tax paid on the partner's behalf by the pass-through entity.
- (d) A pass-through entity shall deliver to the department a return upon a form prescribed by the department showing the total amounts paid or credited to its electing nonresident individual partners, members, or shareholders, the amount paid in accordance with this subsection, and any other information the department may require. A pass-through entity shall furnish to its nonresident partner, member, or shareholder annually, but not later than the fifteenth day of the fourth month after the end of its taxable year, a record of the amount of tax paid on behalf of the partner, member, or shareholder on a form prescribed by the department.

KRS 141.010(25) defines "doing business in this state" as the following:

- (a) Being organized under the laws of this state;
- (b) Having a commercial domicile in this state;
- (c) Owning or leasing property in this state;
- (d) Having one(1) or more individuals performing services in this state;
- (e) Maintaining an interest in a **pass-through entity** doing business in this state;
- (f) Deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state, or deriving income directly or indirectly from a single-member

limited liability company that is doing business in this state and is disregarded as an entity separate from its single member for federal income tax purposes; or

- (g) Directing activities at Kentucky customers for the purpose of selling them goods or services.

Nothing in this subsection shall be interpreted in a manner that goes beyond the limitations imposed and protections provided by the United States Constitution or Pub. L. No. 86-272.

MANDATORY NEXUS REQUIREMENT OF AFFILIATED GROUPS TO FILE CONSOLIDATED RETURNS

KRS 141.200 changed the definition of “affiliated group” for taxable years beginning after December 31, 2006. The chains of includible corporations connected through stock ownership with a common parent corporation no longer include pass-through entities per KRS 141.200(9)(b).

PRACTITIONER'S SCENARIOS

Scenario #1

The taxpayer is a Colorado C corporation that holds an interest in an LLC and the LLC provides its only income. The LLC is multi-state and does business in Kentucky. The LLC is not a disregarded entity for federal purposes. Both entities are in a loss position. How do they file for 2008? Would it be different if the entities had a gain? Would it be different if the tax year was 2005?

Answer:

The Colorado C Corporation would have Kentucky nexus as it owns an interest in a pass-through entity doing business in Kentucky. For 2008, the loss of the Colorado C Corporation and the loss of the LLC would be apportioned to Kentucky based on the sales, property and payroll of the Colorado C Corporation and its proportionate share of the sales, property, and payroll of the LLC. Schedule A and Schedule A-C would be used by the Colorado C corporation to show the apportionment.

For tax year 2005, the Colorado C Corporation would not have a Kentucky filing requirement as it did not have nexus. The LLC would file a Kentucky tax return (Form 765) and pay the greater of the corporation income tax or the AMC (minimum of \$175).

Scenario #2

A Kentucky resident set up a Montana LLC whose only asset was a motor coach. The Kentucky resident's business is construction management for projects all over the United States, but not in Kentucky. For the past two years he has been building restaurants in Utah, Nevada, Texas, and Florida. The RV is used for office purposes and lodging at the construction site. The owner has not worked in Kentucky and the RV may be brought to Kentucky twice a year for maintenance purposes only. Would this LLC have nexus for income tax or limited liability entity tax?

Answer:

If this is a single member LLC, the LLC would have nexus if the owner is (i) domiciled in Kentucky and (ii) participates in the operation. If the LLC is owned by two or more members, the LLC would not have nexus, unless the managing member was a Kentucky resident.

Bringing the RV to Kentucky twice a year for maintenance purpose only, would not create nexus as this activity would be a de minimis activity as provided by subsection (4)(b) of Section 4 of 103 KAR 16:240. An LLC was classified as a corporation when 103 KAR 16:240 (nexus standard for corporations and general partnerships) was written; therefore it is relevant in this scenario.

NEXUS QUESTIONNAIRE

To help in determining the nexus status of a corporation, the Department of Revenue has developed a Nexus Questionnaire for the corporation to complete. The Nexus Questionnaire is used by the DOR to secure information needed to make the best judgment possible. The questionnaire was designed as a tool to help determine the extent of activity a corporation has in Kentucky. A copy of the current Nexus Questionnaire used by the Corporation Tax Section has been included for your reference.

Form 720 (2009)
 Commonwealth of Kentucky
 DEPARTMENT OF REVENUE
 Page 2

SCHEDULE Q—KENTUCKY CORPORATION/LLET QUESTIONNAIRE

IMPORTANT: Questions 4—13 must be completed by all corporations. If this is the corporation’s initial return or if the corporation did not file a return under the same name and same federal I.D. number for the preceding year, questions 1, 2 and 3 must be answered. **Failure to do so may result in a request for a delinquent return.**

1. Indicate whether: (a) new business; (b) successor to previously existing business which was organized as: (1) corporation; (2) partnership; (3) sole proprietorship; or (4) other _____

If successor to previously existing business, give name, address and federal I.D. number of the previous business organization.

2. List the following **Kentucky** account numbers. Enter N/A for any number not applicable.

Employer Withholding _____
 Sales and Use Tax Permit _____
 Consumer Use Tax _____
 Unemployment Insurance _____
 Coal Severance and/or
 Processing Tax _____

3. If a foreign corporation, enter the date qualified to do business in Kentucky. ___ / ___ / ___

4. If change of accounting period, Item F on page 1, is checked, complete the following information:

Year End before the change:

Month _____ and Day _____

- a. Change from a Fiscal Year to a Calendar Year (NOT a 52/53 week filer):
- b. Change from a Calendar Year to a Fiscal Year (NOT a 52/53 week filer):

New Year End:

Month _____ and Day _____

- c. Change from a Fiscal Year to a Calendar Year (52/53 week filer):

New Year End: December and Day of week _____

- d. Change from a Calendar Year to a Fiscal Year (52/53 week filer):

New Year End:

Month _____ and Day of week If a 52/53 week filer: (Choose one of the options below.)

- i. Option A: Ends on the same day of the week and whatever date this same day of the week last occurs in a calendar month.
- ii. Option B: Ends on the same day of the week and whatever date this same day of the week falls that is the nearest to the last day of the calendar month.

5. The corporation’s books are in care of: (name and address)

6. Are disregarded entities included in this return?

Yes No. If yes, list name, address and federal I.D. number of the entity. _____

7. Was the corporation a partner or member in a pass-through entity doing business in Kentucky? Yes No. If yes, attach schedule listing name and federal I.D. number of the pass-through entity. _____

Was the corporation doing business in Kentucky, outside of its interest in a pass-through entity? Yes No

8. Are related party costs made to related members as defined in KRS 141.205(1)(l) included in this return? Yes No. If yes, list name, federal I.D. and/or Kentucky Corporation/LLET account number of the individual or entity.

Caution: If the corporation elected to file a consolidated income tax return for tax years beginning prior to January 1, 2005, skip questions 9 and 10 and go to question 11.

9. Did the corporation at any time during the taxable year do business in Kentucky and own 80 percent or more of the voting stock of another corporation doing business in Kentucky? Yes No. If yes, list name, address and federal I.D. number of the entity.

10. Was 80 percent or more of the corporation's voting stock owned by any corporation doing business in Kentucky at any time of the year? Yes No. If yes, list name, address and federal I.D. number of the entity. _____

11. Was this return prepared on: (a) cash basis, (b) accrual basis, (c) other _____

12. Did the corporation file a Kentucky tangible personal property tax return for January 1, 2010? Yes No

13. Is the corporation currently under audit by the Internal Revenue Service? Yes No

If yes, enter years under audit _____

If the Internal Revenue Service has made final and unappealable adjustments to the corporation's taxable income which have not been reported to the department, check here and file an amended return. See Instructions 2009 Kentucky Corporation Income Tax and LLET Return, page 6 for information regarding amended returns. Attach a copy of the final determination to the amended return.

OFFICER INFORMATION (Failure to Provide Requested Information May Result in a Penalty)

Attach a schedule listing the name, home address and Social Security number of the vice president, secretary and treasurer.

Has the attached officer information changed from the last return filed? Yes No

President's Name President's Home Address

President's Social Security Number

Date Became President

//

I, the undersigned, declare under the penalties of perjury, that I have examined this return, including all accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct and complete.

Signature of principal officer or chief accounting officer Date

Name of person or firm preparing return SSN, PTIN or FEIN

May the DOR discuss this return with the preparer?

Yes No



E-mail Address:

Telephone Number:

www.revenue.ky.gov