Partnerships & Pass-Through Entities

Kentucky
UNBRIDLED SPIRIT

September, 2012
CT-600

OBJECTIVE

The purpose of this manual is to explain the taxation of pass-through entities from tax years beginning January 1, 2007 and forward. The material addresses the flow of income and deductions that flow from a pass-through entity to partners, members or shareholders, how distributive share income is calculated, and where items are reported on the partners', members' or shareholders' tax returns. Various scenarios are presented to illustrate the tax treatment of both individual and corporate partners.

WHAT IS A PASS-THROUGH ENTITY?

KRS 141.010(26) defines *pass-through entity* as "any partnership, S corporation, limited liability company, limited liability partnership, limited partnership, or similar entity recognized by the laws of this state that is not taxed for federal purposes at the entity level, but instead passes to each partner, member, shareholder, or owner their proportionate share of income, deductions, gains, losses, credits, and any other similar attributes."

A **single-member limited liability company** (SMLLC) is a limited liability company (LLC) which has one member. A single-member LLC is a business entity form allowed by a state; this entity is not recognized by the IRS for tax purposes. The SMLLC files taxes as a sole proprietorship, using Schedule C on the member's personal tax return (Form 1040), but it affords the owner liability protection of a separate business entity. A SMLLC can be either a corporation or a single member disregarded entity at the federal level.

If a corporation owns a disregarded entity, that entity is disregarded for both federal and Kentucky tax purposes.

A pass-through entity (PTE) is a legal entity where income *passes through* to investors or owners, which means the income of the entity is treated as the income of the investors or owners. Pass-through entities are also known as flow-through entities or fiscally-transparent entities. Technically, for tax purposes, pass-through entities are considered *non-entities* because taxation *passes through* to another tax return.

It is important to note that a multi-member Limited Liability Company (LLC) must choose at the federal level how it is taxed. It can be taxed as a partnership, an S corporation or a C corporation. Kentucky recognizes the federal election made by the LLC and requires that the entity file the appropriate Kentucky income tax return based upon this election.

The IRS requires a partnership to file an annual tax return reporting the income allocated to owners, and to provide each owner with a statement of allocated income to enable owners to report their shares of income on their own tax returns. The statement of allocated income is known as Schedule K-1. Each partner's distributive share of income or loss is reported on Schedule K-1.

The recipient of the Schedule K-1 reports this pass-through income on their personal or business income tax return. It is important to note that the distributive share of income the partners declare is not related to money distributed by the PTE.

NOTE: Partnerships have partners, whether they're a limited partnership, a general partnership, or a limited liability partnership. S corporations have shareholders. Limited liability companies have members.

INCOME

WHAT PARTNERSHIP INCOME IS TAXABLE TO KENTUCKY?

Resident Individual

In determining tax as provided by KRS Chapter 141, a **resident individual**, estate or trust that is a partner or member of a partnership classified as a limited liability pass-through entity shall take into account the partner's or member's total distributive share of the partnership's items of income, loss and deduction. **KRS 141.206(8)**

Regardless of whether the partnership does business solely in Kentucky, both within and without Kentucky, or solely outside of Kentucky, if the partner is a resident of Kentucky, the entire distributive share will go into his or her Kentucky individual income tax return. The partner will be given credit on his Kentucky Form 740 for tax paid to another state, if applicable.

Nonresident Individual

In determining tax as provided by KRS Chapter 141, a **nonresident individual**, estate or trust that is a partner or member of a partnership shall take into account: (1) if the partnership is doing business only in this state, the partner's or member's total distributive share of the partnership's items of income, loss and deduction; or (2) if the partnership is doing business both within and without this state, the partner's or member's total distributive share of the partnership's items of income, loss and deduction multiplied by the apportionment fraction as provided by KRS 141.206(12). **KRS 141.206(9)**

WHAT IS DISTRIBUTIVE SHARE INCOME?

Distributive share refers to the allocation of income, loss, deduction, or credit from a partnership to a partner. The allocation of distributive share income or loss is generally determined by the partnership agreement, and the total percentage share of all partners will equal 100 per cent of the profit or loss. The partnership nets nonseparately stated income and expenses, and reports the net income or loss to partners.

It is important to note that the partnership agreement may include one set of percentages of profit for partners and a totally different set of percentage for losses. The partnership agreement is the governing document regarding how the partnership's profit and losses will be split among the partners but the total of all partners' percentages will equal 100 per cent.

Partnership Ordinary Income or Loss

Section 702(a)(8) of the Internal Revenue Code requires reporting as a separate category all of the partnership's taxable income or loss that is not otherwise required to be stated separately under Section 702(a). This is the amount that is reflected on the last line of page one on the Form 1065 as the ordinary income or (loss) of the partnership and is also the amount that is to be apportioned to the partners on their respective K-1s. Because the amount of income or loss is found on the bottom line of Page 1, Form 1065, it is often referred to as **bottom line** income or loss.

Included in this bottom line income or loss are such items as gross profits from sales, administrative, and operating expenses. These items represent the actual income and expenses of operating the business that are not subject to special limitations. In addition, other categories of income, such as depreciation recapture (Section 1245), are included as partnership ordinary income because it represents ordinary income that is not subject to any preferential treatment.

This ordinary business income gets multiplied by the partner's percentage of ownership and, in the case of a nonresident partner, is also multiplied by the partner’s taxable percentage of the partnership’s distributive share items according to the amount in box D(2) of the Kentucky Schedule K-1 if the partnership is doing business both within and without Kentucky. That percentage comes from the apportionment factor found on the partnership’s Schedule A of their Form 765.

Dividend Income Passed Through a K-1

KRS 141.010(12)(b) states that gross income in the case of corporations excludes all dividend income received after Dec. 31, 1969. Therefore, dividend income from a K-1 to a corporate partner is not taxable to Kentucky and should be a subtraction from income on the corporate partner’s Form 720. It would also be excluded from the sales factor in both the partnership’s factors as well as from the distributive share income that goes in the sales factor of the corporate partner.

Reporting Partnership Taxable Income

A partner’s distributive share is actually the portion of partnership taxable and nontaxable income that the partner must report for tax purposes. It should not be confused with the amount actually distributed to a partner. Actual distributions in a given year may be more or less than the distributive share reported by the partner.

Nonbusiness Income

A partnership itself does not have nonbusiness income. A corporate partner may classify part or all of the income of the partnership to be nonbusiness income on its Form 720 Schedule A. However, the Kentucky Department of Revenue should reclassify the nonbusiness income to business income and request substantiation of the nonbusiness income before allowing.

CALCULATING TAXABLE INCOME

Partnership taxable income is calculated much the same way as the taxable income of individuals with a few differences mandated by the Internal Revenue Code. First, taxable income is divided into two categories; separately stated items and partnership ordinary income (loss).

Generally, the calculation of partnership income is a two-step approach:

Step 1: Net ordinary income and expenses related to the trade or business of the partnership. The result equals ordinary partnership taxable income (loss).

Step 2: Segregate and report separately items of income, expense, gain or loss that might affect any two partners' tax liabilities differently, it is a separately stated item. These are separately stated items.

Separately Stated Items Reported on Schedule K-1

The partnership must report certain income and expenses separately from the net profit or loss amount. These income and expense items retain their tax characteristics when passed through to the partner, and are subject to the limits and tax rates on each partner's personal Form 1040.

Separately stated items are allocated in proportion to each partner's percentage of ownership in the partnership. Separately stated items include the following:

- Section 1231 gains and losses;
- Net short-term capital gains and losses;
- Net long-term capital gains and losses;
- Dividends;
- Charitable contributions;
- Taxes paid to a foreign country;
- Tax-exempt interest and related expenses;
- Investment income and expenses;
- Amounts previously deducted, such as bad debts;
- Real estate income and expenses;
- Passive activity items (rental real estate income or loss);

- Section 179 deductions;
- Guaranteed payments;
- Tax credits and
- Nondeductible expenses, such as 50 per cent of meals and entertainment expenses.

GUARANTEED PAYMENTS

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. Guaranteed payments are treated as a partner's distributive share of ordinary income.

The partnership lists guaranteed payments on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with his or her distributive share of the partnership's other ordinary income.

APPORTIONMENT

General—A pass-through entity that is taxable in this state and taxable in another state shall apportion and allocate net income to Kentucky in accordance with **KRS 141.206(12)**.

Corporations that are taxable in Kentucky and other states apportion and allocate net income to Kentucky in accordance with **KRS 141.120**. A corporation must use the statutory formula unless it has been required or granted approval in writing by the Department of Revenue to use an alternative method provided by **KRS 141.120(9)(a)** or the corporation qualifies for and elects an alternative apportionment method provided by **KRS 141.120(9)(b)**.

Consolidated Return—An affiliated group filing a consolidated return is treated as a single corporation. All transactions between members of the affiliated group are eliminated in determining the sales, property and payroll factors.

COMPUTATION OF APPORTIONMENT FRACTION

Schedule A must be completed and submitted with the applicable tax return (Form 720, Form 720S, Form 725, Form 765 or Form 765-GP). If the corporation or limited liability pass-through entity filing the tax return is a partner, member, or shareholder of a limited liability pass-through entity or general partnership organized or formed as a general partnership after January 1, 2006, or if the general partnership filing the partnership income return is a partner or member of a pass-through entity, Schedule A-C must be completed to show the apportionment factors of each entity that are included in the total factors of the taxpayer filing the return.

For a corporation or limited liability pass-through entity that is not a partner, member, or shareholder of a limited liability pass-through entity or general partnership organized or formed as a general partnership after January 1, 2006, or a general partnership that is not a partner or member of a pass-through entity, the business apportionment factors shall be computed as follows:

Sales—Total sales include all gross receipts other than nonbusiness receipts. Sales of real or tangible personal property are assigned to Kentucky if the property is located in Kentucky or is shipped or delivered to a purchaser in Kentucky. Sales of tangible personal property to the U.S. government are assigned to Kentucky if the property is shipped from Kentucky. **KRS 141.120(8)(c)(3**) provides that sales other than sales of tangible personal property are assigned to Kentucky if the income-producing activity is performed entirely within Kentucky or if the income producing activity is performed both within and without Kentucky and a greater portion of the income-producing activity is performed in Kentucky than in any other state based on cost of performance. The following are general guidelines for assigning these receipts to Kentucky, but should not be considered all inclusive:

A. Receipts from intangibles are assigned to Kentucky if the corporation's commercial domicile is in Kentucky or the intangible has acquired a Kentucky business situs. Examples of receipts from intangibles which are deemed to have acquired a Kentucky business situs are franchise fees from a franchisee located in

Kentucky and a corporation's Kentucky distributive share of net income from a partnership doing business in Kentucky.

B. Rents or royalties from real or tangible personal property are assigned to Kentucky if the property is located in Kentucky or in the case of mobile property the rent is assigned to Kentucky if the lessee's base of operations for the property is in Kentucky.

C. Receipts from the performance of services are assigned to Kentucky if the services are performed entirely in Kentucky or the services are performed both within and without Kentucky, but a greater portion is performed in Kentucky than in any other state based on cost of performance.

D. For tax years beginning on or after January 1, 2008, KRS 141.121 changed the way some intangibles are included in the sales factor. Instead of being the total purchase price, only the net gain from the disposal of liquid assets that produce business income shall be included in the numerator and denominator of the sales factor. Liquid assets are commonly referred to as having a treasury function, meaning they are short-term investments that can be easily converted to cash. KRS 141.121(1) defines liquid assets as including foreign currency used in the regular course of the corporation's trade or business; marketable instruments, including stocks, bonds, debentures, options, warrants and futures contracts; and mutual funds which hold liquid assets. All other intangible assets that are not considered liquid assets or short-term investments are included at the total sales price rather than the net gain.

Property—Total property includes all real and tangible personal property owned or rented and used during the taxable year. Property owned is valued at original cost. Leased property is valued at eight times the annual rental rate less any nonbusiness subrentals.

Real and tangible personal properties are assigned to Kentucky if owned or rented and used in Kentucky. Exclude (a) construction in progress and (b) property which has been certified by Kentucky as a pollution control facility and is owned or leased by the corporation. Safe harbor lease property must be included in the factor of the seller/lessee at cost and excluded from the property factor of the purchaser/lessor.

Payroll—Total payroll includes all compensation paid or payable by the corporation during the tax period. Kentucky payroll is that portion of total payroll that is paid or payable for services performed within the state. Compensation is paid or payable in this state if the service is performed entirely within the state, the service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state or if the individual's residence is in this state and some of the service is performed in the state and the base of operations or the place from which the service is directed is in this state or in any state in which none of the service is performed.

Apportionment Fraction—To compute the apportionment fraction, the sales factor must be multiplied by two and the property and payroll factors must each be multiplied by one and the total divided by four. If any one of the sales, property or payroll factors has no denominator, then the number of factors to divide by is reduced by the number of factors having no denominator, or reduced by two if the sales factor has a zero denominator. If the factor has a number in the denominator but not in the numerator, it is still counted in the total apportionment fraction even though the factor for that particular category is zero. Statutory authority for this is **KRS 141.206(12)**. Pass-through entities must apportion all income without regard to whether it is business or nonbusiness. It cannot be classified as nonbusiness income until it reaches the corporate partner’s return, if applicable.

CALCULATION OF RECEIPTS FOR CORPORATE PARTNERS

In 2005, the nexus standard in this state was expanded from a physical presence, i.e., having sales, property or payroll in Kentucky to a *doing business* standard as provided by KRS 141.010(25). KRS 141.010(25)(e) provides that a corporation is doing business in this state if it maintains an interest in a pass-through entity doing business in this state.

KRS 141.206(10) provides that 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 deductions 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 141.206(12) 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 sales, property, and payroll of the limited liability pass-through entity or general partnership in computing its own apportionment factor; and

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 KRS 141.206(10)(a).

A Kentucky pass-through entity must include on the appropriate Kentucky Schedule K its Kentucky sales, property and payroll, and total sales, property, and payroll from Schedule A. Each partner should be provided a Kentucky K-1 reflecting the partner's proportionate share of sales, property, and payroll.

A corporation that owns an interest in a limited liability pass-through entity shall attach Kentucky Schedule A-C, in addition to Kentucky Schedule A, to its tax return in order to compute its Kentucky sales, property, and payroll and its total sales, property, and payroll. Kentucky Schedule A-C is used to show the corporation's sales, property, and payroll and its proportional share of sales, property, and payroll from each limited liability pass-through entity or general partnership for which it has an ownership interest.

Additionally, a corporation that owns an interest in a pass-through entity doing business in Kentucky shall include its pro rata share of the distributive share income in its sales factor, the numerator of which is the distributive share income from the pass-through entity multiplied by the pass-through entity's apportionment fraction and the denominator is the distributive share income.

The items of the distributive share income to be included in the sales factor of the corporate partner are identical to the items that are included in a normal sales factor under KRS 141.120 and 103 KAR 16:270. Negative amounts, such as ordinary income loss or capital loss, would not be included in the distributive share income for the sales factor.

A corporation that owns an interest in a pass-through entity not doing business in Kentucky shall include its pro rata share of the distributive income in the denominator of its sales factor.

LIMITED LIABILITY ENTITY TAX (LLET)

KRS 141.0401 defines **Kentucky** gross receipts. Per KRS 141.0401 (1)(a):

"Kentucky gross receipts" means an amount equal to the **computation of the numerator** of the sales factor under the provisions of KRS 141.120(8)(c), KRS 141.120(9), any administrative regulations related to the computation of the sales factor, and KRS 141.121 and includes the proportionate share of Kentucky gross receipts of all wholly or partially owned limited liability pass-through entities, including all layers of a multi-layered pass-through structure;

Gross receipts from **all sources** is defined per KRS 141.0401 (1)(b):

"Gross receipts from all sources" means an amount equal to the **computation of the denominator** of the sales factor under the provisions of KRS 141.120(8)(c), KRS 141.120(9), any administrative regulations related to the computation of the sales factor, and KRS 141.121 and includes the proportionate share of gross receipts from all sources of all wholly or partially owned limited liability pass-through entities, including all layers of a multi-layered pass-through structure;

Gross receipts for LLET purposes are computed exactly the same as the sales factor for corporations and pass-through entities that are owners in a pass-through entity with nexus in Kentucky. Schedule LLET-C, Limited Liability Entity Tax—Continuation Sheet, is required if the corporation or limited liability pass-through entity filing the tax return is a partner or member of a limited liability pass-through entity or general partnership (organized or formed as a general partnership after January 1, 2006) doing business in Kentucky. Schedule LLET-C is completed with the pass-through entity's Kentucky and total gross receipts and gross profits as well as the partner's Kentucky and total gross receipts and gross profits. The total of those figures flow to Schedule LLET for the computation of the partner's LLET.

FORMS

FORMS USED

An S corporation will file federal Form 1120S and Kentucky Form 720S. A limited liability company, a limited partnership, a limited liability partnership, as well as some other legal limited liability entities that have elected to file as a partnership at the federal level will file federal Form 1065 and Kentucky Form 765. A limited liability company has the choice at the federal level to be taxed as a C corporation (Form 1120 and Kentucky Form 720) or an S corporation (Form 1120-S and Kentucky Form 720S). An LLC that has not elected to be taxed as a C corporation or an S corporation will be taxed as a partnership. Kentucky recognizes the federal *check the box* election. The status of the LLC, for Kentucky tax purposes, is the same as elected for the federal tax return. A single member LLC (SMLLC) can be taxed as a C corporation or as a pass-through entity. For both federal and Kentucky purposes, a C corporation that is the single member of a SMLLC is totally disregarded and all of the income, expenses, deductions and credit of the SMLLC are included in the C corporation's tax returns in both Form 1120 and Form 720. If a SMLLC is owned by an individual, trust, estate or general partnership, Kentucky Form 725 must be filed and LLET paid at the entity level. A resident or nonresident individual single member shall be entitled to a nonrefundable LLET credit against Kentucky individual income, which is the amount of the LLET tax for the current year after the subtraction of any credits identified in KRS 141.0205 and reduced by the $175 minimum.

NOTE: You cannot assume an LLC is taxed as a partnership. Always review the federal return to determine the tax status of the entity.

Schedule K Amounts Flow to K-1

The partner receives a federal K-1, which is that partner's proportionate share of the items on Schedule K of the federal tax return. The Kentucky K-1 amounts are taken from the Kentucky tax return's Schedule K. The Kentucky Schedule K begins with Kentucky ordinary income as shown on the bottom of page 1 of the Kentucky return. This income consists of federal ordinary income adjusted for federal/Kentucky differences. Any differences between the federal Schedule K and the Kentucky Schedule K should be for statutory differences found in KRS 141.010. See appendix for the contents of KRS 141.010(10) and (11).

In instances when a Kentucky tax return is not required to be filed, there will be no Kentucky K-1, and thus federal amounts are used to prepare the partner's Kentucky tax return pursuant to KRS 141.206(13). This would be the case with a partnership that does business solely outside of Kentucky, but the partner is a Kentucky resident.

The total of all partners' federal K-1s should match the amounts reported on the partnership's federal Schedule K. Likewise, the total of all partners' Kentucky K-1s should match the amounts reported on the partnership's Kentucky Schedule K.

Page 1 of the partnership's Kentucky return is where differences in Kentucky/federal income are reported. The partnership's Form 765 starts out with federal ordinary income or loss and then the statutory differences are added or subtracted to reach Kentucky ordinary income.

The Kentucky ordinary income, after accounting for statutory differences between Kentucky and federal, is reported on the first line of the Schedule K. Then Kentucky separately stated items, after accounting for statutory differences between Kentucky and federal, are reported. For example, if federal portfolio income excluded interest from the bonds of other states, that amount would be taxable to Kentucky and must be included in portfolio interest income on Schedule K, Kentucky Form 765.

HOW THE FEDERAL SCHEDULE K-1 FLOWS:

The figures on the federal Schedule K-1 come directly from Schedule K on the federal Form 1065 or Form 1120S and are multiplied by each partner's percentage of income or loss. The Schedule K-1 starts with the partner's share of ordinary business income, followed by its share of separately stated items.

HOW THE KENTUCKY SCHEDULE K- 1 FLOWS:

The amounts on the Kentucky Schedule K-1 come directly from Schedule K on the Kentucky Form 765, Form 765-GP or Form 720S and represent the partner's percentage of the partnership's income, loss, deductions and credits, also known as the distributive share. To determine the amount of distributive share income that is reported on the partner's Kentucky tax return you must consider whether the partner is a resident or nonresident, individual or corporation.
In addition, you must consider whether the partnership does business entirely within Kentucky, within and without Kentucky, or completely outside of Kentucky in order to compute the correct apportionment factor.

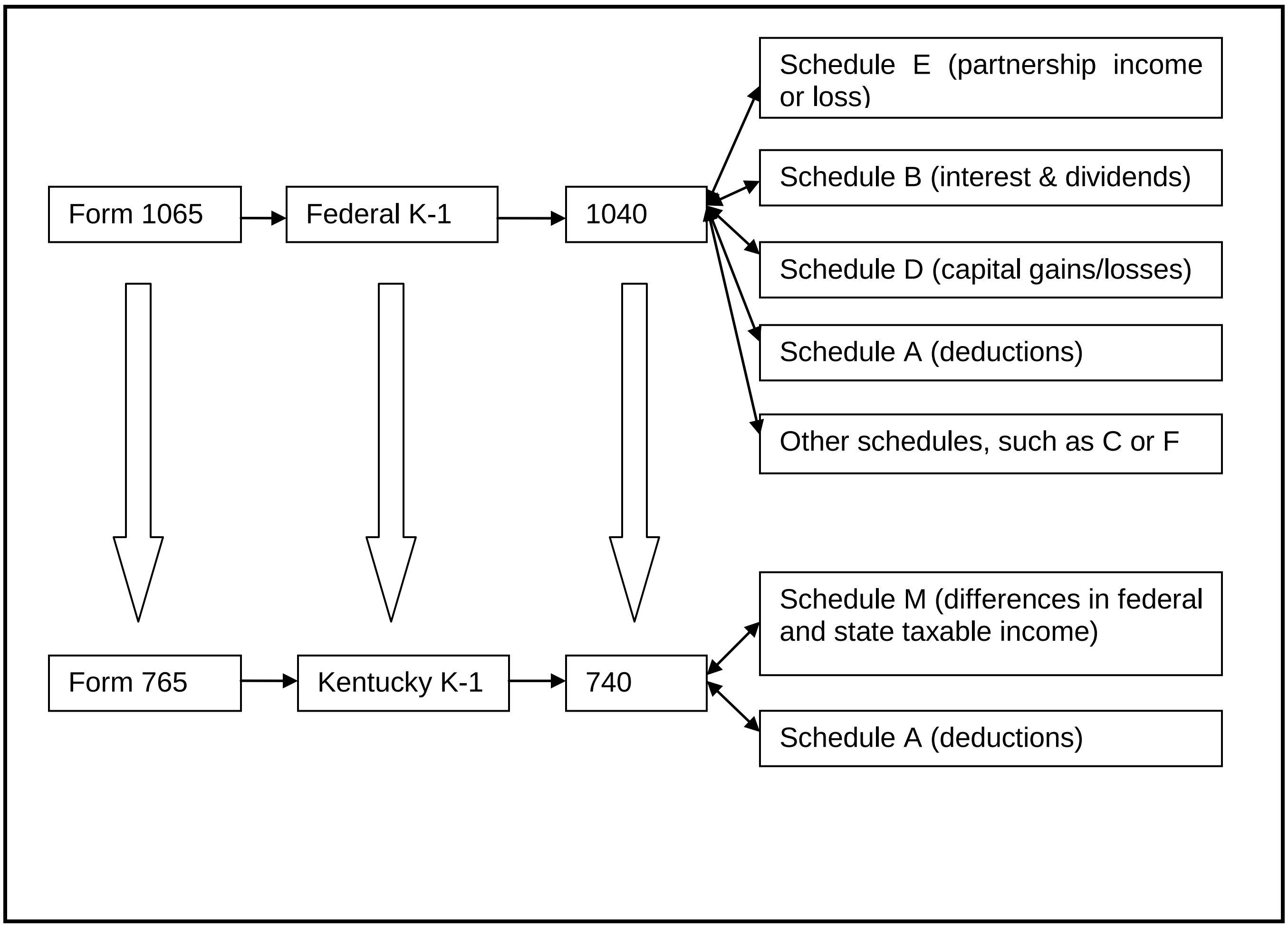
Kentucky residents will report 100 per cent of the amounts shown on the K-1 on their individual or business tax return. Nonresident partners must multiply the amounts on their K-1's by their apportionment factor.

A nonresident partner's apportionment factor can be found on Page 1 of the Kentucky K-1. The nonresident individual partner will use the apportionment factor of the partnership to multiply by the distributive share income to ascertain the partner's pro rata share of that income to be reported on the partner's appropriate Kentucky tax return.

The items found on the federal K-1 and will be included in the partner's federal return. Because federal income is the starting point for Kentucky income, adjustments may be necessary for statutory differences between federal and Kentucky income. Any differences between the amounts reported on the federal Schedule K-1 and the Kentucky Schedule K-1 are included in the *Resident Partner Adjustment* or *Resident Shareholder Adjustment* section. That difference is entered on Schedule M of the Kentucky Form 740 (for individuals) or Kentucky Schedule O-720 or Kentucky Schedule O-PTE (for corporations or partnerships) as either an addition or subtraction to income.

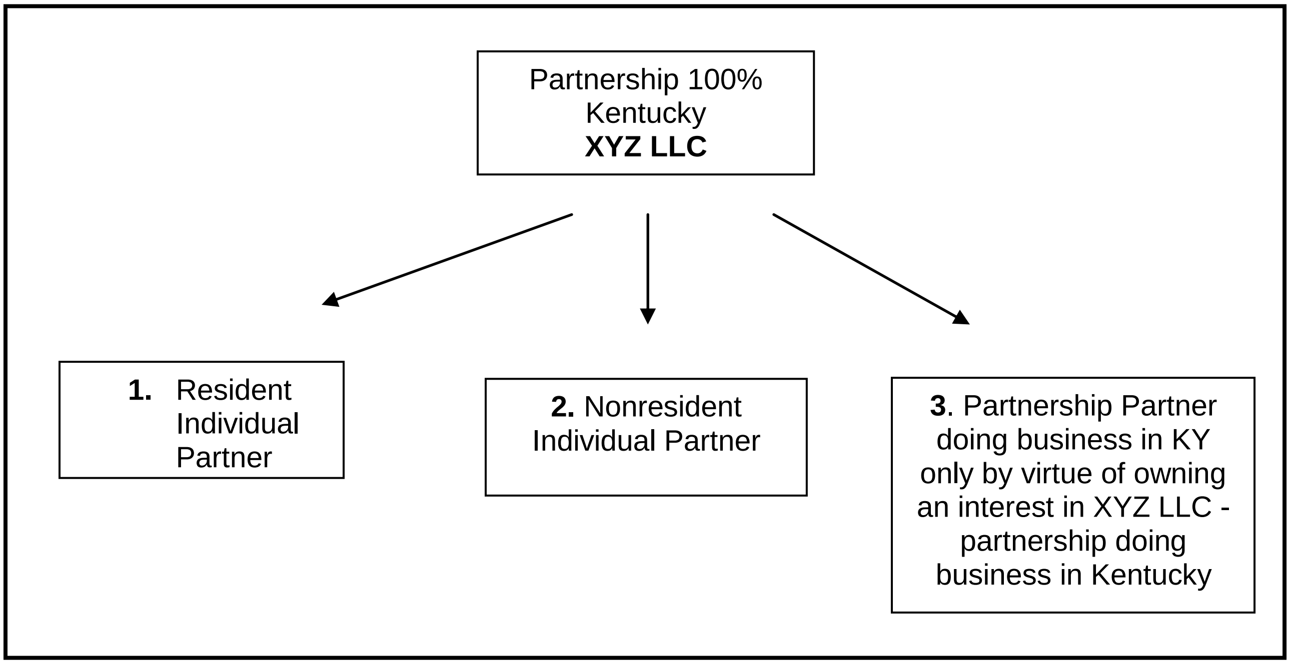
The subsequent sections for reporting distributive share items include nonrefundable tax credits, Form 5695-K pass-through amounts, and refundable credits. The amounts in the *Tax Credits* section of the K-1 are entered on Kentucky Form 740, Section A for individuals or Kentucky Schedule TCS for corporate partners. Kentucky Form 5695-K pass-through amounts on the K-1 should be entered on the applicable line(s) of the partner's Kentucky Form 5695-K.

HOW THE INCOME FLOWS FROM A PARTNERSHIP TO AN INDIVIDUAL



SCENARIOS FOR INDIVIDUAL PARTNERS

SCENARIO 1 – Partnership is doing business 100% in Kentucky



Partner #1 – Resident individual partner – Generally, all income of Kentucky residents, regardless of where it was earned, is subject to Kentucky income tax regardless of whether the partnership is doing business solely in Kentucky, both within and without Kentucky, or completely outside of Kentucky.

The federal K-1 income flows through to the individual taxpayer's return by being included in the federal adjusted gross income. However, due to Kentucky and federal statutory differences, adjustments may be needed. The resident partner or resident shareholder section of the Kentucky K-1 is used for these adjustments. Amounts reported in this section are then reported on Kentucky Schedule M, which flows to the Kentucky Form 740.

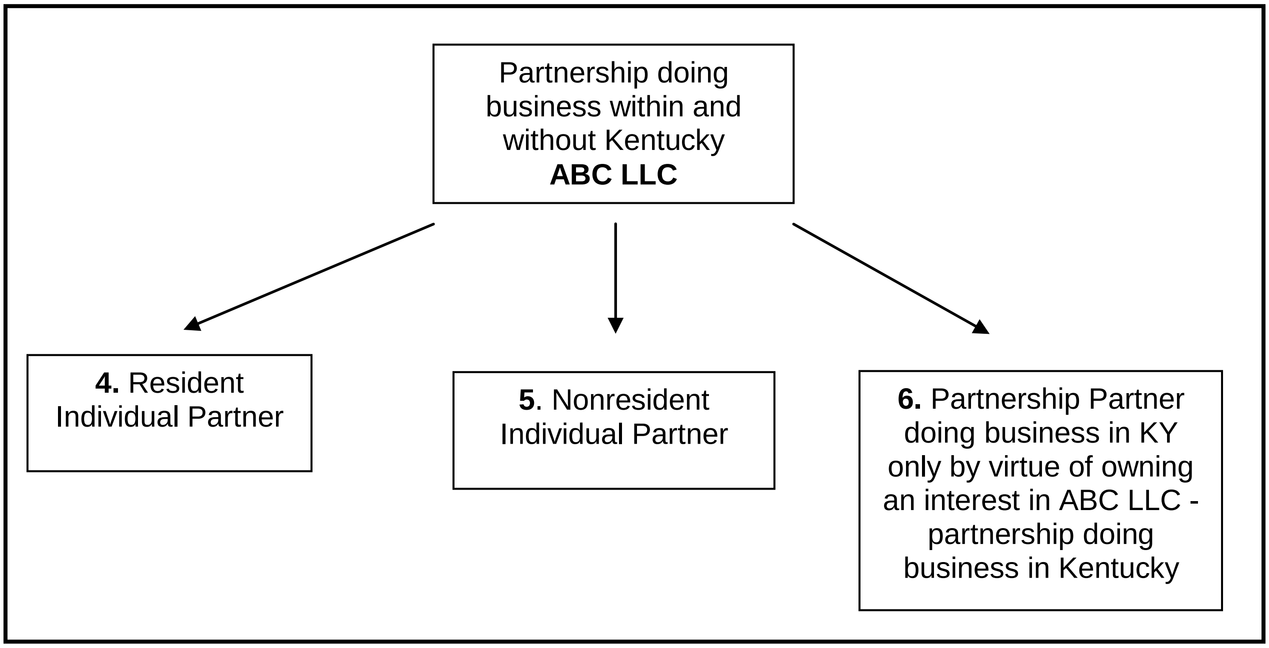
Partner #2 – Nonresident individual partner - A nonresident individual who is required to file Form 740-NP, Kentucky Individual Income Tax Return Nonresident or Part-Year Resident, or who elects to file Form 740-NP to take advantage of capital loss and net operating loss carryovers shall enter the amounts of Schedule K-1, Column (b) as follows:

The nonresident individual's apportionment factor will be 100% because the partnership is 100% Kentucky.

Partner #3 – Nonresident partnership partner – The Kentucky income from the partnership flows through to the partnership partner. Because the partnership partner has nexus in Kentucky by virtue of being a partner in a partnership doing business in Kentucky, KRS 141.120 states that it must apportion its income using Kentucky Schedule A-C which must be attached to its Form 765. Kentucky Schedule A-C is required if the partnership filing the tax return is a partner of a partnership doing business in Kentucky. The Kentucky Schedule A-C flows to the Kentucky Schedule A of the partnership partner.

NOTE: A partnership that owns an interest in a partnership doing business in Kentucky must also include its pro rata share of the distributive share income in its sales factor. The numerator is the distributive share income from the partnership multiplied by the partnership's apportionment fraction and the denominator is the distributive share income.

SCENARIO 2 – Multi-State Partnership is doing business within and without Kentucky



Partner #4 – Resident individual partner – Generally, all income of Kentucky residents, regardless of where it was earned, is subject to Kentucky income tax regardless of whether the partnership is doing business solely in Kentucky, both within and without Kentucky, or completely outside of Kentucky.

The federal K-1 income flows through to the individual taxpayer's return by being included in the federal adjusted gross income. However, due to Kentucky and federal statutory differences, adjustments may be needed. The resident partner or resident shareholder section of the Kentucky K-1 is used for these adjustments. Amounts reported in this section are then reported on Kentucky Schedule M, which flows to the Kentucky Form 740.

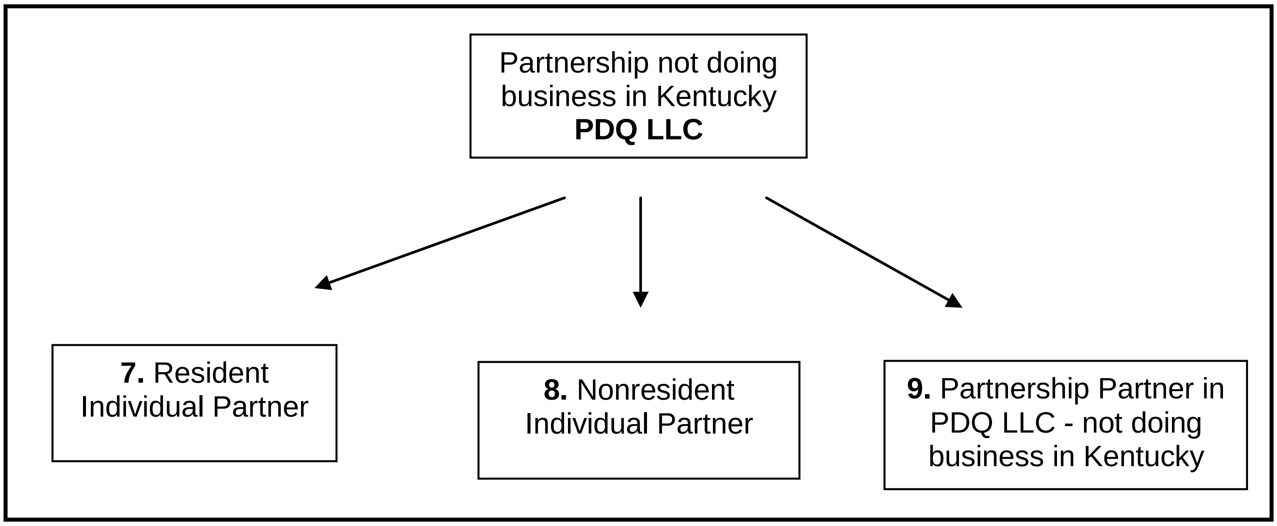
Partner #5 – Nonresident individual partner - A nonresident individual partner will use Kentucky Form 740-NP. Because the partnership does business both within and without Kentucky, its apportionment factor will be shown on line D(2) of the Kentucky Schedule K-1. The nonresident partner will multiply items on the

Kentucky Schedule K-1 by that apportionment fraction and will put those amounts on Kentucky Form 740-NP and on the appropriate schedules, if applicable.

Partner #6 – Partnership partner doing business in KY only by virtue of owning an interest in a partnership doing business in Kentucky - The Kentucky income from the partnership flows through to the partnership partner. Because the partnership partner has nexus in Kentucky by virtue of being a partner in a partnership doing business in Kentucky, KRS 141.120 states that it must apportion its income using Schedule A-C which must be attached to its Form 765. Schedule A-C is required if the partnership filing the tax return is a partner of a partnership doing business in Kentucky. Schedule A-C rolls into the Schedule A of the partnership partner.

A partnership that owns an interest in a partnership doing business in Kentucky must also include its pro rata share of the distributive share income in its sales factor. The numerator is the distributive share income from the partnership multiplied by the partnership's apportionment fraction and the denominator is the distributive share income.

SCENARIO 3 – Partnership is not doing business in Kentucky



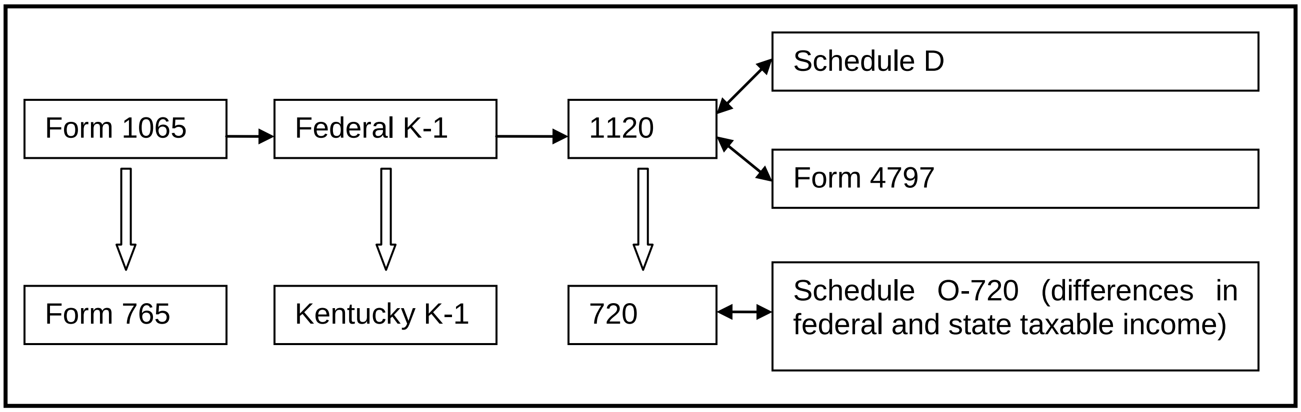
Partner #7 – Resident individual partner – Generally, all income of Kentucky residents, regardless of where it was earned, is subject to Kentucky income tax regardless of whether the partnership is doing business solely in Kentucky, both within and without Kentucky, or completely outside of Kentucky.

The federal K-1 income flows through to the individual taxpayer's return by being included in the federal adjusted gross income.

Partner #8 – Nonresident individual partner – No Kentucky return necessary.

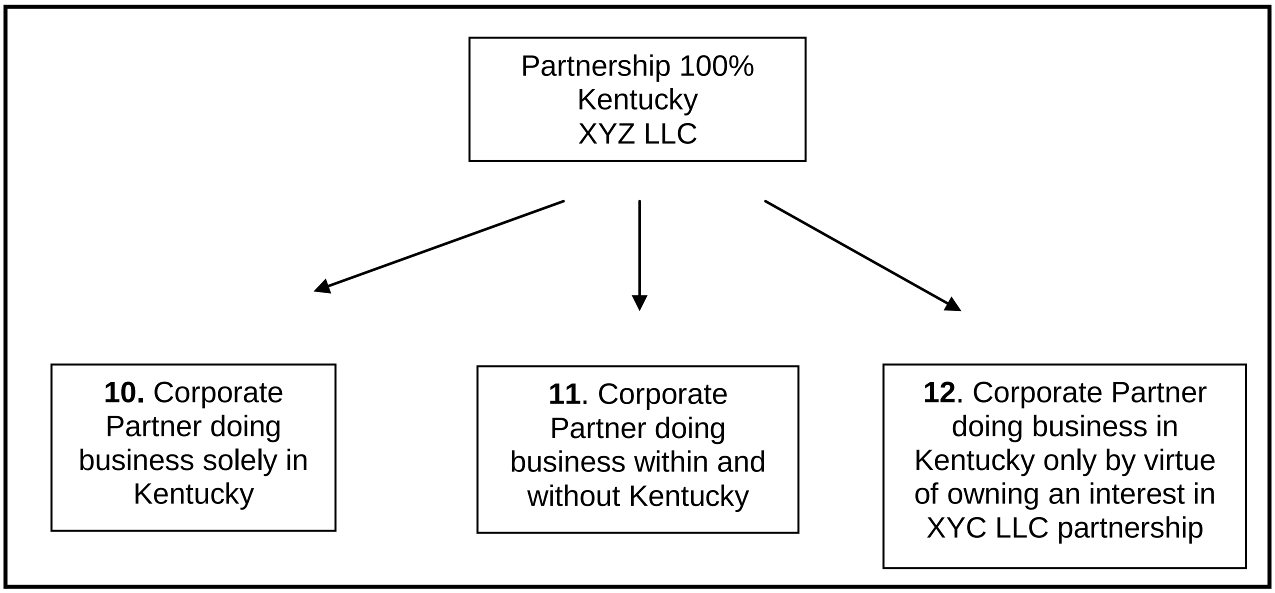
Partner #9 – Partnership partner not doing business in Kentucky – No Kentucky return necessary.

HOW THE INCOME FLOWS FROM A PARTNERSHIP TO A CORPORATION



CORPORATE PARTNERS

SCENARIO 1 – Partnership 100% Kentucky



XYZ LLC partnership must attach Schedule A to Kentucky Form 765 to show its Kentucky apportionment factors, even though it is a 100 per cent Kentucky partnership. It must give each partner a Kentucky Schedule K-1 showing the partner's proportionate share of the partnership's income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll and total payroll. The information on the Kentucky K-1 comes straight from the partnership's Kentucky Form 765, Schedule K, and is multiplied by the partner's percentages of profit sharing and loss sharing.

NOTE: It is possible for the percentages of profit sharing and loss sharing to be different, based on the terms of the partnership agreement.

Partner #10 – Corporate partner doing business solely in Kentucky - A corporate partner doing business solely within Kentucky that owns an interest in a partnership doing business solely within Kentucky shall include its total distributive share of the partnership's items of income, loss and deduction from the Kentucky K-1 on its Kentucky Form 720.

The partnership shall give each partner a Kentucky Schedule K-1 showing the partner’s proportionate share of the partnership’s income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll.

Partner #11 – Corporate partner doing business within and without Kentucky - A corporate partner doing business within and without Kentucky that owns an interest in a partnership doing business solely within Kentucky shall include its total distributive share of the partnership’s items of income, loss and deduction from the Kentucky K-1 on its Kentucky Form 720.

The partnership shall give each partner a Kentucky Schedule K-1 showing the partner’s proportionate share of the partnership’s income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll. A corporate partner doing business within and without Kentucky that owns an interest in a partnership doing business solely within Kentucky shall complete Kentucky Schedule A-C, in addition to Kentucky Schedule A, to compute its apportionment factors.

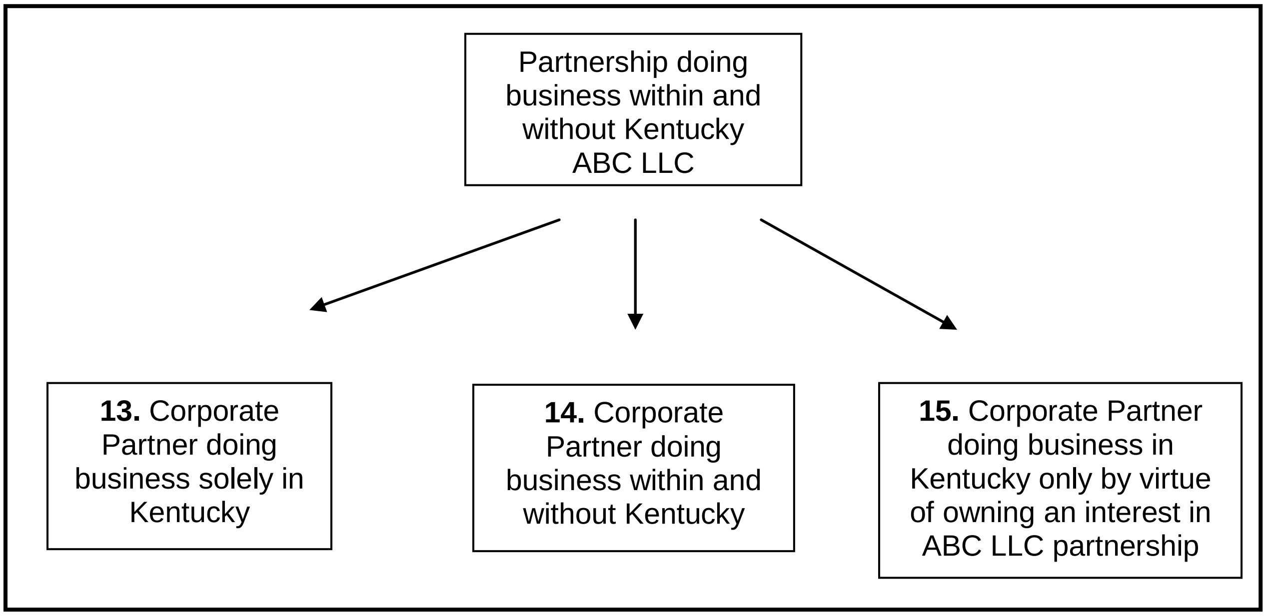
Apportionment factors – Partner #11 would combine on Kentucky Schedule A-C its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll with its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll from Schedule K -1. Partner # 11 Kentucky sales and total sales would include the distributive share income from the partnership since the partnership is 100 per cent Kentucky.

Partner #12 – Corporate partner doing business in Kentucky only through its ownership interest in a partnership doing business in Kentucky - A corporate partner doing business in Kentucky only through its ownership interest in a partnership doing business solely in Kentucky shall include its total distributive share of the partnership’s items of income, loss and deduction from the Kentucky K-1 on its Kentucky Form 720.

The partnership shall give each partner a Kentucky Schedule K-1 showing the partner's proportionate share of the partnership's income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll. A corporate partner doing business in Kentucky only through its ownership interest in a partnership doing business solely in Kentucky shall complete Kentucky Schedule A-C, in addition to Kentucky Schedule A, to compute its apportionment factors.

Apportionment factors – Partner #12 would combine on Kentucky Schedule A-C its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll with its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll from Schedule K -1. Partner #12's Kentucky sales and total sales would include the distributive share income from the partnership since the partnership is 100 per cent Kentucky.

SCENARIO 2 – Partnership doing business within and without Kentucky



ABC LLC partnership must file Form 765 and Schedule A to show its Kentucky apportionment factors. It must give all partners a Kentucky Schedule K-1 showing that partner's proportionate share of the partnership's income according to its percentage of ownership. The information on the K-1 comes straight from the partnership's Form 765 Schedule K and is multiplied by the partner's percentages of profit sharing and loss sharing.

Partner #13 – Corporate partner doing business solely in Kentucky - A corporate partner doing business solely in Kentucky that owns an interest in a partnership doing business within and without Kentucky, shall include its total distributive share of the partnership's items of income, loss and deduction from the Kentucky K-1 on its Kentucky Form 720.

The partnership shall give each partner a Kentucky Schedule K-1 showing the partner's proportionate share of the partnership's income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll. A corporate partner doing business solely in Kentucky that owns an interest in a partnership doing business within and without Kentucky shall complete Kentucky

Schedule A-C, in addition to Kentucky Schedule A, to compute its apportionment factors.

Apportionment factors – Partner #13 would combine on Schedule A-C its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll with its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll from Schedule K -1. Partner #13 would include in its Kentucky sales the distributive share income from the partnership multiplied by the apportionment fraction shown on the Kentucky Schedule K-1, Line D(2), and in its total sales, the distributive share income from the partnership.

Partner #14 – Corporate partner doing business within and without Kentucky - A corporate partner, doing business within and without Kentucky that owns an interest in a partnership doing business within and without Kentucky, shall include its total distributive share of the partnership's items of income, loss and deduction from the Kentucky K-1 on its Kentucky Form 720.

The partnership shall give each partner a Kentucky Schedule K-1 showing the partner's proportionate share of the partnership's income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll. A corporate partner doing business within and without Kentucky that owns an interest in a partnership doing business within and without Kentucky shall complete Kentucky Schedule A-C, in addition to Kentucky Schedule A, to compute its apportionment factors.

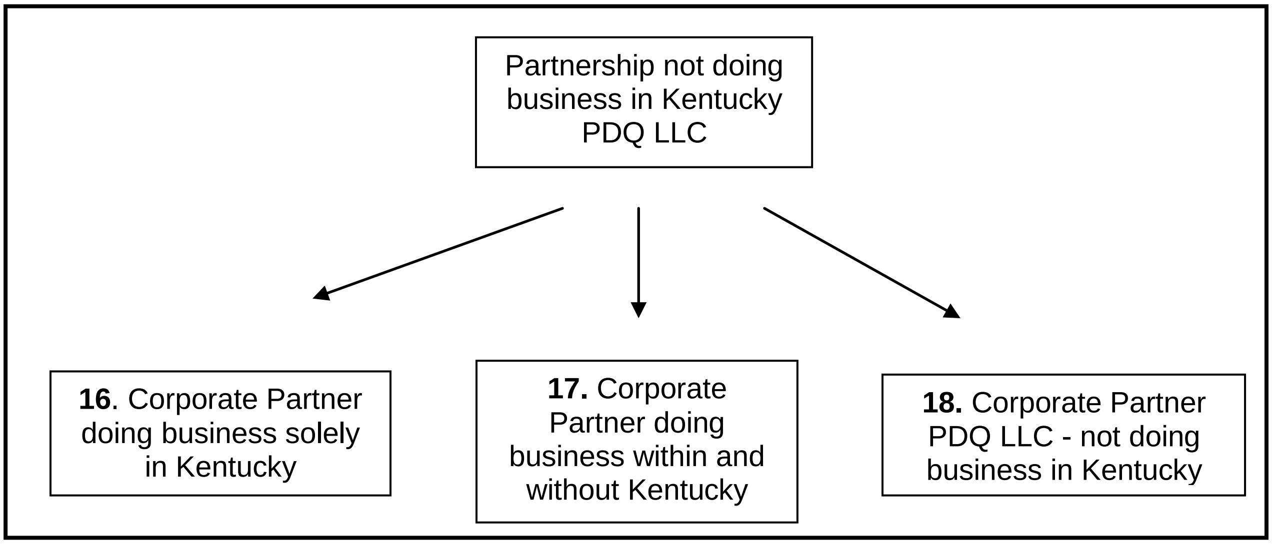
Apportionment factors – Partner #14 would combine on Kentucky Schedule A-C its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll with its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll from Schedule K -1. Partner # 14 would include in its Kentucky sales the distributive share income from the partnership multiplied by the apportionment fraction shown on the Kentucky Schedule K-1, Line D(2), and in its total sales the distributive share income from the partnership.

Partner #15 – Corporate partner doing business in Kentucky only through its ownership interest in a partnership doing business within and without Kentucky - A corporate partner doing business in Kentucky only through its ownership interest in a partnership doing business within and without Kentucky shall include its total distributive share of the partnership's items of income, loss and deduction from the Kentucky K-1 on its Kentucky Form 720.

The partnership shall give each partner a Kentucky Schedule K-1 showing the partner's proportionate share of the partnership's income, Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll. A corporate partner doing business in Kentucky only through its ownership interest in a partnership doing business within and without in Kentucky shall complete Kentucky Schedule A-C, in addition to Kentucky Schedule A, to compute its apportionment factors.

Apportionment factors – Partner #15 would combine on Kentucky Schedule A-C its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll with its Kentucky sales, total sales, Kentucky property, total property, Kentucky payroll, and total payroll from Kentucky Schedule K -1. Partner # 15 would include in its Kentucky sales the distributive share income from the partnership multiplied by the apportionment fraction shown on the Kentucky Schedule K-1, and in its total sales the distributive share income from the partnership.

SCENARIO 3 – Partnership not doing business in Kentucky



Because the partnership does not conduct business in Kentucky, has no sales, property or payroll in Kentucky, and does not own an interest in a limited liability entity doing business in Kentucky, there is no filing requirement for the partnership in Kentucky. Any corporate partner who does business in Kentucky will use the numbers from the federal K-1 to prepare their Kentucky return. Because the partnership does not do business in Kentucky and does not give the partner a Kentucky Schedule K-1, there are no numbers given for the apportionment factors of the partnership. Schedule A-C is not necessary and the corporate partner would only need to complete Schedule A. However, the distributive share income would still be included in the denominator of the sales factor of the corporate partner.

Partner #16 – Corporate partner doing business solely in Kentucky - A corporate partner doing business solely in Kentucky that owns an interest in a partnership not doing business in Kentucky shall include its total distributive share of the partnership's items of income, loss and deduction from the federal K-1 on its Kentucky Form 720.

Partner #17 – Corporate partner doing business within and without Kentucky - A corporate partner doing business within and without Kentucky that owns an interest in a partnership not doing business in Kentucky shall include its total distributive share of the partnership's items of income, loss and deduction from the federal K-1 on its Kentucky Form 720.

Partner #18 – Corporate partner not doing business in Kentucky - A corporate partner not doing business in Kentucky that owns an interest in a partnership not doing business in Kentucky does not have a Kentucky filing requirement.

APPENDIX

STATUTORY AUTHORITY

For years beginning January 1, 2007:

KRS 141.206 Filing of returns by pass-through entities – Withholding requirements on owners of pass-through entities – Apportionment issues for pass-through entities – Composite returns.

(1) As used in this section unless the context requires otherwise:

(a) For taxable years beginning after December 31, 2004, and before January 1, 2007, "pass-through entity" means a general partnership not subject to the tax imposed by KRS 141.040, including any publicly traded partnership as defined by Section 7704(b) of the Internal Revenue Code that is treated as a partnership for federal tax purposes under Section 7704(c) of the Internal Revenue Code and its publicly traded partnership affiliates. "Publicly traded partnership affiliates" shall include any limited liability company or limited partnership for which at least eighty percent (80%) of the limited liability company member interests or limited partner interests are owned directly or indirectly by the publicly traded partnership; and

(b) For all other taxable years, "pass-through entity" means pass-through entity as defined in KRS 141.010.

(2) Every pass-through entity doing business in this state 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 tax return with the form prescribed and furnished by the department.

(3) Pass-through entities shall determine net 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 net income under this section and the computation of the partner's, member's, or shareholder's 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.

(4) Individuals, estates, trusts, or corporations doing business in this state as a partner, member, or shareholder in a pass-through entity shall be liable for income tax only in their individual, fiduciary, or corporate capacities, and no income tax shall be assessed against the net income of any pass-through entity, except as required for S corporations by KRS 141.040(14).

(5) (a) Every pass-through entity required to file a return under subsection (2) of this section, except publicly traded partnerships as defined in KRS 141.0401(6)(r), shall withhold Kentucky income tax on the distributive share, whether distributed or undistributed, of each:

1. Nonresident individual partner, member, or shareholder; and

2. Corporate partner or member that is doing business in Kentucky only through its ownership interest in a pass-through entity.

(b) Withholding shall be at the maximum rate provided in KRS 141.020 or 141.040.

(6) (a) Effective for taxable years beginning after December 31, 2011, every pass-through entity required to withhold Kentucky income tax as provided by subsection (5) of this section shall make a declaration and payment of estimated tax for the taxable year if:

1. For a nonresident individual partner, member, or shareholder, the estimated tax liability can reasonably be expected to exceed five hundred dollars ($500); or

2. For a corporate partner or member that is doing business in Kentucky only through its ownership interest in a pass-through entity, the estimated tax liability can reasonably be expected to exceed five thousand dollars ($5,000).

(b) The declaration and payment of estimated tax shall contain the information and shall be filed as provided in KRS 141.207.

(7) (a) If a pass-through entity demonstrates to the department that a partner, member, or shareholder has filed an appropriate tax return for the prior year with the department, then the pass-through entity shall not be required to withhold on that partner, member, or shareholder for the current year unless the exemption from withholding has been revoked pursuant to paragraph (b) of this subsection.

(b) An exemption from withholding shall be considered revoked if the partner, member, or shareholder does not file and pay all taxes due in a timely manner. An exemption so revoked shall be reinstated only with permission of the department. If a partner, member, or shareholder who has been exempted from withholding does not file a return or pay the tax due, the department may require the pass-through entity to pay to the department the amount that should have been withheld, up to the amount of the partner's, member's, or shareholder's ownership interest in the entity. The pass-through entity shall be entitled to recover a payment made pursuant to this paragraph from the partner, member, or shareholder on whose behalf the payment was made.

(8) In determining the tax under this chapter, a resident individual, estate, or trust that is a partner, member, or shareholder in a pass-through entity shall take into account the partner's, member's, or shareholder's total distributive share of the pass-through entity's items of income, loss, deduction, and credit.

(9) In determining the tax under this chapter, a nonresident individual, estate, or trust that is a partner, member, or shareholder in a pass-through entity required to file a return under subsection (2) of this section shall take into account:

(a) 1. If the pass-through entity is doing business only in this state, the partner's, member's, or shareholder's total distributive share of the pass-through entity's items of income, loss, and deduction; or

2. If the pass-through entity is doing business both within and without this state, the partner's, member's, or shareholder's distributive share of the pass-through entity's items of income, loss, and deduction multiplied by the apportionment fraction of the pass-through entity as prescribed in subsection (12) of this section; and (b) The partner's, member's, or shareholder's total distributive share of credits of the pass-through entity.

(10) 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 (12) 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.

(11) (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 (12) 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 (12) of this section.

(12) 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).

(13) 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.

(14) 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.

(15) (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.

(16) (a) 1. A pass-through entity may file a composite income tax return on behalf of electing nonresident individual partners, members, or shareholders.

2. The pass-through entity shall report and pay on the composite income tax return income tax at the highest marginal rate provided in this chapter on any portion of

the partners', members', or shareholders' pro rata or distributive shares of income of the pass-through entity from doing business in this state or deriving income from sources within this state. Payments made pursuant to subsection (6) of this section shall be credited against any tax due.

3. The pass-through entity filing a composite return shall still make estimated tax payments if required to do so by subsection (6) of this section, and shall remain subject to any penalty provided by KRS 131.180 or 141.990 for any declaration underpayment or any installment not paid on time.

4. 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.

Effective: June 4, 2010

DIFFERENCES BETWEEN FEDERAL AND KENTUCKY INCOME

INDIVIDUALS

KRS 141.010(10) states:

"Adjusted gross income," in the case of taxpayers other than corporations, means gross income as defined in subsection (9) of this section ["gross income" as defined in Section 61 of the Internal Revenue Code] minus the deductions allowed individuals by Section 62 of the Internal Revenue Code and as modified by KRS 141.0101 [depreciation methods and transitional rules] and adjusted as follows, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter, and except that nothing in this chapter shall be construed to permit the same item to be deducted more than once:

(a) Exclude income that is exempt from state taxation by the Kentucky Constitution and the Constitution and statutory laws of the United States and Kentucky;
(b) Exclude income from supplemental annuities provided by the Railroad Retirement Act of 1937 as amended and which are subject to federal income tax by Public Law 89-699;
(c) Include interest income derived from obligations of sister states and political subdivisions thereof [i.e., municipal bonds];
(d) Exclude employee pension contributions picked up as provided for in KRS 6.505, 16.545, 21.360, 61.560, 65.155, 67A.320, 67A.510, 78.610, and 161.540 upon a ruling by the Internal Revenue Service or the federal courts that these contributions shall not be included as gross income until such time as the contributions are distributed or made available to the employee;
(e) Exclude Social Security and railroad retirement benefits subject to federal income tax;
(f) Include, for taxable years ending before January 1, 1991, all overpayments of federal income tax refunded or credited for taxable years;
(g) Deduct, for taxable years ending before January 1, 1991, federal income tax paid for taxable years ending before January 1, 1990;
(h) Exclude any money received because of a settlement or judgment in a lawsuit brought against a manufacturer or distributor of "Agent Orange" for damages resulting from exposure to Agent Orange by a member or veteran of the Armed Forces of the United States or any dependent of such person who served in Vietnam;
(i) 1. For taxable years ending prior to December 31, 2005, exclude the applicable amount of total distributions from pension plans, annuity congtracts, profit-sharing plans, retirement plans, or employee savings plans.
   The "applicable amount" shall be:
   a. Twenty-five percent (25%), but not more than six thousand two hundred fifty dollars ($6,250), for taxable years beginning after December 31, 1994, and before January 1, 1996;
   b. Fifty percent (50%), but not more than twelve thousand five hundred dollars ($12,500), for taxable years beginning after December 31, 1995, and before January 1, 1997;

c. Seventy-five percent (75%), but not more than eighteen thousand seven hundred fifty dollars ($18,750), for taxable years beginning after December 31, 1996, and before January 1, 1998; and
d. One hundred percent (100%), but not more than thirty-five thousand dollars ($35,000), for taxable years beginning after December 31, 1997.

2. For taxable years beginning after December 31, 2005, exclude up to forty-one thousand one hundred ten dollars ($41,110) of total distributions from pension plans, annuity contracts, profit-sharing plans, retirement plans, or employee savings plans.
3. As used in this paragraph:
   a. "Distributions" includes but is not limited to any lump-sum distribution from pension or profit-sharing plans qualifying for the income tax averaging provisions of Section 402 of the Internal Revenue Code; any distribution from an individual retirement account as defined in Section 408 of the Internal Revenue Code; and any disability pension distribution;
   b. "Annuity contract" has the same meaning as set forth in Section 1035 of the Internal Revenue Code; and
   c. "Pension plans, profit-sharing plans, retirement plans, or employee savings plans" means any trust or other entity created or organized under a written retirement plan and forming part of a stock bonus, pension, or profit-sharing plan of a public or private employer for the exclusive benefit of employees or their beneficiaries and includes plans qualified or unqualified under Section 401 of the Internal Revenue Code and individual retirement accounts as defined in Section 408 of the Internal Revenue Code;

(j) 1. a. Exclude the portion of the distributive share of a shareholder's net income from an S corporation subject to the franchise tax imposed under KRS 136.505 [for financial institutions] or the capital stock tax imposed under KRS 136.300 [for financial institutions]; and
   b. Exclude the portion of the distributive share of a shareholder's net income from an S corporation related to a qualified subchapter S sub subsidiary subject to the franchise tax imposed under KRS 136.505 or the capital stock tax imposed under KRS 136.300.

2. The shareholder's basis of stock held in a S corporation where the S corporation or its qualified subchapter S subsidiary is subject to the franchise tax imposed under KRS 136.505 o the capital stock tax imposed under KRS 136.300 shall be the same as the basis for federal income tax purposes;

(k) Exclude for taxable years beginning after December 31, 1998, to the extent not already excluded from gross income, any amounts paid for health insurance, or the value of any voucher or similar instrument used to provide health insurance, which constitutes medical care coverage for the taxpayer, the taxpayer's spouse, and dependents during the taxable year. Any amounts paid by the taxpayer for health insurance that are excluded pursuant to this paragraph shall not be allowed as a deduction in computing the taxpayer's net income under subsection (11) of this section;

(l) Exclude income received for services performed as a precinct worker for election training or for working at election booths in state, county, and local primary, regular, or special elections;

(m) Exclude any amount paid during the taxable year for insurance for long-term care as defined in KRS 304.14-600;

(n) Exclude any capital gains income attributable to property taken by eminent domain;
(o) Exclude any amount received by a producer of tobacco or a tobacco quota owner from the multistate settlement with the tobacco industry, known as the Master Settlement Agreement, signed on November 22, 1998;
(p) Exclude any amount received from the secondary settlement fun, referred to as "Phase II," established by tobacco companies to compensate tobacco farmers and quota owners for anticipated financial losses caused by the national tobacco settlement;
(q) Exclude any amount received from funds of the Commodity Credit Corporation for the Tobacco Loss Assistance Program as a result of a reduction in the quantity of tobacco quota allotted;
(r) Exclude any amount received as a result of a tobacco quota buydown program that all quota owners and growers are eligible to participate in;
(s) Exclude state Phase II payments received by a producer of tobacco or a tobacco quota owner;
(t) Exclude all income from all sources for active duty and reserve members and officers of the Armed Forces of the United States or National Guard who are killed in the line of duty, for the year during which the death occurred. For the purposes of this paragraph, "all income from all sources shall include all federal and state death benefits payable to the estate or any beneficiaries; and
(u) For taxable years beginning on or after January 1, 2010, exclude all military pay received by active duty members of the Armed Forces of the United States, members of reserve components of the Armed Forces of the United States, and members of the National Guard, including compensation for state active duty as described in KRS 38.205.

DIFFERENCES BETWEEN FEDERAL AND KENTUCKY INCOME

CORPORATIONS

KRS 141.010(12) states:

"Gross income," in the case of corporations, means "gross income" as defined in Section 61 of the Internal Revenue Code and as modified by KRS 141.0101 and adjusted as follows:
(a) Exclude income that is exempt from state taxation by the Kentucky Constitution and the Constitution and statutory laws of the United States;

- (b) Exclude all dividend income received after December 31, 1969;
- (c) Include interest income derived from obligations of sister states and political subdivisions thereof;
- (d) Exclude fifty percent (50%) of gross income derived from any disposal of coal covered by Section 631(c) of the Internal Revenue Code if the corporation does not claim any deduction for percentage depletion, or for expenditures attributable to the making and administering of the contract under which such disposition occurs or to the preservation of the economic interests retained under such contract;
- (e) Include in the gross income of lessors income tax payments made by lessees to lessors, under the provisions of Section 110 of the Internal Revenue Code, and exclude such payments from the gross income of lessees;
- (f) Include the amount calculated under KRS 141.205;
- (g) Ignore the provisions of Section 281 of the Internal Revenue Code in computing gross income;
- (h) Exclude income from "safe harbor leases" (Section 168(f)(8) of the Internal Revenue Code);
- (i) Exclude any amount received by a producer of tobacco or a tobacco quota owner from the multistate settlement with the tobacco industry, known as the Master Settlement Agreement, signed on November 22, 1998;
- (j) Exclude any amount received from the secondary settlement fund, referred to as "Phase II," established by tobacco companies to compensate tobacco farmers and quota owners for anticipated financial losses caused by the national tobacco settlement;
- (k) Exclude any amount received from funds of the Commodity Credit Corporation for the Tobacco Loss Assistance Program as a result of a reduction in the quantity of tobacco quota allotted;
- (l) Exclude any amount received as a result of a tobacco quota buydown program that all quota owners and growers are eligible to participate in;
- (m) For taxable years beginning after December 31, 2004, and before January 1, 2007, exclude the distributive share income or loss received from a corporation defined in subsection (24)(b) of this section whose income has been subject to the tax imposed by KRS 141.040. The exclusion provided in this paragraph shall also apply to a taxable year that begins prior to January 1, 2005, if the tax imposed by KRS 141.040 is paid on the distributive share income by a corporation defined in subparagraphs 2. to 8. of subsection (24)(b) of this section with a return filed for a period of less than twelve (12) months that begins on or after January 1, 2005, and ends on or before December 31, 2005. This paragraph shall not be used to delay payment of the tax imposed by KRS 141.040; and

(n) Exclude state Phase II payments received by a producer of tobacco or a tobacco quota owner[.]