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(FILE NO. 2007-SC-0846-D)**

Commonwealth of Kentucky
Court of Appeals

NO. 2006-CA-002175-MR

COMMONWEALTH OF KENTUCKY,
FINANCE AND ADMINISTRATION
CABINET, DEPARTMENT OF REVENUE

APPELLANT

v. APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE THOMAS D. WINGATE, JUDGE
ACTION NO. 05-CI-01558

AUTOZONE DEVELOPMENT CORPORATION

APPELLEE

OPINION
AFFIRMING

** ** *

BEFORE: LAMBERT, TAYLOR, AND WINE, JUDGES.

TAYLOR, JUDGE: Commonwealth of Kentucky, Finance and Administration Cabinet,
Department of Revenue (Department) brings this appeal from an October 4, 2006, Order
of the Franklin Circuit Court which affirmed a decision of the Kentucky Board of Tax

Appeals (KBTA) determining that AutoZone Development Corporation (AutoZone) was entitled to a tax deduction for dividends paid to shareholders. We affirm.

AutoZone is a Nevada corporation that began doing business in Kentucky in 1995. AutoZone owns and leases land and buildings in Kentucky for the operation of its business. AutoZone is a federally qualified Real Estate Investment Trust (REIT) pursuant to 26 U.S.C. §§ 856-859 of the United States Internal Revenue Code. AutoZone timely filed its Kentucky corporate income tax returns for the years 1995-1997. On those returns, AutoZone claimed a deduction from gross income for dividends paid to its shareholders. This deduction resulted in ninety-five percent of AutoZone's income being sheltered from Kentucky's corporate income tax.

The Department disallowed this deduction for each of the three years (1995, 1996, and 1997) and assessed additional income tax liability on AutoZone in the amount of \$663,722.00, plus interest and penalties. The assessment was affirmed by the Department in a final ruling. AutoZone appealed that ruling to the KBTA. Kentucky Revised Statutes (KRS) 131.340. KBTA determined that the deduction for dividends paid to AutoZone's shareholders was an allowable deduction. Thus, in an October 10, 2005, order, KBTA vacated the ruling of the Department and set aside the assessment. KRS 131.365; KRS 13B.120. The Department appealed KBTA's decision to the Franklin Circuit Court. KRS 131.370; KRS 13B.140. In an October 4, 2006, order, the circuit court affirmed the ruling of KBTA. This appeal follows.

The Department contends KBTA erroneously decided that AutoZone properly claimed as a deduction from gross income dividends paid to shareholders upon

its Kentucky corporate tax returns for the years 1995-1997. For the reasons hereinafter elucidated, we disagree.

When reviewing an administrative agency's decision, we step into the shoes of the circuit court and review the agency's decision for arbitrariness. *Com. v. Weinberg*, 150 S.W.3d 75 (Ky.App. 2004). In this appeal, the material facts are undisputed, and we are presented with a pure question of law – whether KRS 141.010(13) permits a federally qualified REIT to claim a deduction from gross income for dividends paid shareholders for the purpose of calculating the REIT's net income on its state tax return. Our review of an administrative agency's interpretation or application of law is *de novo*. *Camera Center, Inc. v. Revenue Cabinet*, 34 S.W.3d 39 (Ky. 2000). As such, our analysis shall proceed accordingly.

KRS 141.010(13)¹ states, in part, as follows:

“Net income,” in the case of corporations, means “gross income” as defined in subsection (12) of this section minus the deduction allowed by KRS 141.0202 and minus all the deductions from gross income allowed corporations by Chapter 1 of the Internal Revenue Code and as modified by KRS 141.0101

Under KRS 141.010(13), a corporation's net income is generally derived by taking its gross income and then subtracting deductions allowed from gross income under KRS 141.0202 and Chapter 1 of the Internal Revenue Code, as modified by KRS 141.0101.

¹ We refer to that version of Kentucky Revised Statutes (KRS) 141.010(13) as it existed in 1995, 1996, and 1997. During those years, KRS 141.010(13) remained unchanged. This opinion should not be misconstrued as having any effect upon other versions of KRS 141.010(13).

In its October 10, 2005, order, KBTA concluded that 26 U.S.C. § 857(b)(2)(B)² of the Internal Revenue Code permits a federally qualified REIT to claim a deduction for dividends paid to shareholders during the relevant taxable year. In determining the “dividends paid deduction”³ was an allowable deduction under KRS 141.010(13), the KBTA reasoned:

8. KRS § 141.010(13) requires that if a deduction from gross income is allowed under Internal Revenue Code Chapter 1 and it is not later disallowed or modified by Kentucky statute then it must be allowed as a deduction for Kentucky corporation income tax purposes.
9. The “dividends paid deduction” is included in Chapter 1 of the Internal Revenue Code, and it is not later disallowed or modified by Kentucky Statute.
10. Therefore, the “dividends paid deduction[”] is an allowable deduction for Kentucky corporation income tax purposes.

The Department disagrees with KBTA's interpretation of KRS 141.010(13) and claims that “[t]he dividends paid deduction allowed REITs under Federal law is an adjustment to taxable income, a special treatment provision, not a deduction from gross income.” Department's Brief at 17. In particular, the Department argues:

The Internal Revenue Code then allows a REIT certain adjustments to its *taxable income* before calculating its tax liability, including an adjustment to reflect the distribution of dividends actually paid to its shareholders. Thus, after determining what amount is 90 percent of its taxable income,

² We refer to that version of 26 U.S.C. § 857(b)(2)(B) as it existed in 1995, 1996, and 1997. During those years, 26 U.S.C. § 857 (b)(2)(B) remained unchanged. This opinion should not be misconstrued as having any effect upon other versions of 26 U.S.C. § 857(b)(2)(B).

³ In this opinion, we sometimes refer to the deduction for dividends paid to shareholders under 26 U.S.C. § 857(b)(2)(B) as the “dividends paid deduction.”

a REIT may deduct the dividends paid to shareholders currently from *taxable income*, not gross income. Indeed, if the deduction was from gross income, the REIT would be unable to determine what constituted 90 percent of its taxable income.

Thus, the deduction for dividends paid to shareholders is not a deduction from *gross income* allowed to be taken by all corporations under Chapter 1 of the Internal Revenue Code; instead, it is an adjustment to *taxable income* allowed exclusively to REITs. Contrary to the Franklin Circuit Court's holding, under the plain language of KRS 141.010(13), the dividends paid deduction is not a deduction allowed when a corporation is determining “net income” for Kentucky income tax purposes because the deduction is not from gross income.

Department's Brief at 6.

According to the Department, the dividends paid deduction is an adjustment to taxable income under the Internal Revenue Code. The Department further argues that KRS 141.010(13) plainly limits allowable deductions to those taken from gross income of a corporation. As the dividends paid deduction is an adjustment to taxable income rather than to gross income, the Department maintains this deduction is not allowable under KRS 141.010(13).

We agree with the Department that KRS 141.010(13) clearly and unmistakably defines “net income” as gross income minus all deductions from gross income allowed by Chapter 1 of the Internal Revenue Code. Under Chapter 1 of the Internal Revenue Code, the dividends paid deduction is specifically codified in 26 U.S.C. § 857(b)(2)(B) and provides:

(b) Method of taxation of real estate investment trusts and holders of shares or certificates of beneficial interest.--

(1) Imposition of tax on real estate investment trusts.--
There is hereby imposed for each taxable year on the real

estate investment trust taxable income of every real estate investment trust a tax computed as provided in section 11, as though the real estate investment trust taxable income were the taxable income referred to in section 11.

(2) Real estate investment trust taxable income.-- For purposes of this part, the term “real estate investment trust taxable income” means the taxable income of the real estate investment trust, adjusted as follows:

. . . .

(B) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to that portion of such deduction which is attributable to the amount excluded under subparagraph (D).

Although the dividends paid deduction is technically an adjustment to taxable income, our inquiry cannot end here. *See* 26 U.S.C. § 857(b)(2)(B). The issue of whether the dividends paid deduction, as codified in 26 U.S.C. § 857(b)(2)(B), is an allowable deduction under KRS 141.010(13) has never been addressed in this Commonwealth. However, we are guided by the reasoning contained in *Revenue Cabinet v. General Motors Corporation*, 794 S.W.2d 178 (Ky.App. 1990).

In *General Motors*, the Court rejected the Revenue Cabinet's “literal” reading of KRS 141.010(13), which rendered an out-of-state sales or gross receipt tax nondeductible. *Id.* Instead, the Court stressed that a functional equivalency analysis must be performed to determine if the tax was properly deductible under KRS 141.010(13). Under this functional equivalency analysis, the Court stated that the “character of any tax must be determined by its operation and effect.” *Id.* at 179. We view the reasoning of *General Motors* broad enough to encompass this case. *See id.*

In the case *sub judice*, we believe the hypertechnical reading of KRS 141.010(13), as advanced by the Department, must be rejected. Rather, we conclude that the functional equivalency analysis must be applied to determine whether the dividends paid deduction, as found in 26 U.S.C. § 857(b)(2)(B), is an allowable deduction under KRS 141.010(13). Under this analysis, we recognize that the character of the deduction and its operation and effect are paramount.

Under the Internal Revenue Code, taxable income is basically defined as gross income minus all deductions allowed by Chapter 1. 26 U.S.C. § 63(a);⁴ 10 Kathleen Bicek Bezdichek, *Mertens Law of Fed. Income Tax'n* § 39:58 (2007). To correctly calculate a REIT's taxable income, all of the deductions allowed under Chapter 1 must be subtracted. 26 U.S.C. § 63(a). The dividends paid deduction available to a REIT is found in Chapter 1 (26 U.S.C. § 857(b)(2)(B)); thus, the dividends paid deduction must be subtracted to arrive at the REIT's taxable income. Although the dividends paid deduction is taken from taxable income, the deduction's ultimate function is to arrive at the "REIT's taxable income." While the terminology utilized for the dividend paid deduction in 26 U.S.C. § 857(b)(2)(B) is admittedly confusing, it is clear that the dividends paid deduction is functionally utilized to arrive at the REIT's taxable income and effectively operates to reduce the REIT's taxable income for federal taxation purposes.

Our Court has recognized that taxable income, as utilized in the Internal Revenue Code (26 U.S.C. § 63(a)), and net income, as used in KRS 141.010(13), are

⁴ We refer to that version of 26 U.S.C. § 63(a) as it existed in 1995, 1996, and 1997; this subsection remained unchanged during those years.

virtually “the same.” *General Motors*, 794 S.W.2d 178, 179. An allowable deduction under KRS 141.010(13) is functionally utilized to arrive at a corporation's net income and effectively operates to reduce a corporation's net income for state taxation purposes. As the deduction for dividends paid is also utilized to arrive at and effectively reduce a REIT's taxable income for federal taxation purposes, we hold that the deduction for dividends paid, as codified in 26 U.S.C. § 857(b)(2)(B), is the functional equivalent of an allowable deduction from gross income under KRS 141.010(13). Consequently, we are of the opinion that the deduction for dividends paid, codified in 26 U.S.C. § 857(b)(2)(B), is an allowable deduction to gross income of a REIT under KRS 141.010(13).

Accordingly, we hold KBTA's decision that AutoZone properly claimed a deduction for dividends paid to shareholders on its 1995, 1996, and 1997 Kentucky corporate income tax returns was not arbitrary. *See Weinberg*, 150 S.W.3d 75.

For the foregoing reasons, the Order of the Franklin Circuit Court is affirmed.

ALL CONCUR.

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