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Commonwealth of Kentucky

Court of Appeals

NO. 2018-CA-001517-MR

STEPHEN RIDGE AND BRIGETTE RIDGE — APPELLANTS

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HON. JUDGE PHILLIP J. SHEPHERD
ACTION NO. 18-CI-00719

COMMONWEALTH OF KENTUCKY
FINANCE AND ADMINISTRATION CABINET,
DEPARTMENT OF REVENUE; AND
COMMONWEALTH OF KENTUCKY,
KENTUCKY CLAIMS COMMISSION — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: GOODWINE, SPALDING, AND L. THOMPSON, JUDGES.

SPALDING, JUDGE: From 2005 until 2015, Stephen Ridge, a resident of Tennessee, maintained employment with Fruit of the Loom in Bowling Green, Kentucky. Ridge ended his employment with Fruit of the Loom, effective December 31, 2015. On his last day of employment, Ridge and Fruit of the Loom

entered into a written agreement under which Ridge was to receive various benefits in exchange for, among other things, his agreement to be bound by a non-compete and non-solicitation clause. Among these benefits was payment by Fruit of the Loom to Ridge in "an amount equal to twenty-six (26) weeks of [Ridge's] regular salary less applicable payroll deductions" – *i.e.*, $84,919.00. The following year, in 2016, Ridge received the aforementioned amount in twenty-six (26) bi-weekly installments. Fruit of the Loom withheld Kentucky state income taxes from these installments.

In filing his 2016 Kentucky Individual Income Tax Return, Ridge sought a refund of the withheld amount since "same were paid post-retirement and were not the result of any 'activity' in the Commonwealth during taxable year (2016)." Ridge's request for a refund was denied by the Kentucky Department of Revenue (the "Department"). A lengthy administrative process followed.

Ridge first filed a written protest with the Department's Division of Protest and Resolution. In August of 2017, Ridge received a "Final Ruling" which denied his protest. Ridge then filed an "Appeal Petition of Non Resident" in September of 2017 with the Kentucky Claims Commission (the "Commission"). On February 15, 2018, Ridge filed a motion for summary judgment with the Commission, and on June 27, 2018, the Commission issued its "Final Order," denying the Ridge's appeal.

Ridge subsequently petitioned the Franklin Circuit Court, seeking review of the Commission's Final Order. The circuit court found the argument of the Commission persuasive, finding "severance pay" to qualify as "taxable wages" under applicable statutory and case law, holding ultimately that Ridge "did business" in Kentucky during Tax Year 2016. This appeal followed.

This Court may overturn an administrative decision only if the agency that made the decision acted arbitrarily and outside the scope of its statutory authority, either because the agency applied an incorrect rule of law or made a decision that was not supported by substantial evidence on the record. *Kentucky State Racing Commission v. Fuller*, 481 S.W.2d 298, 301 (Ky. 1972). If it is determined that an agency's findings are supported by substantial evidence, it will be affirmed if it correctly applied the law with the facts as found. *Kentucky Unemployment Insurance Commission v. Landmark Community Newspapers of Kentucky, Inc.*, 91 S.W.3d 575, 578 (Ky. 2002) (citing *Southern Bell Tel. & Tel. Co. v. Kentucky Unemployment Ins. Comm'n*, 437 S.W.2d 775, 778 (Ky. 1969)). Questions of law arising out of administrative proceedings are fully reviewable *de novo* by the courts. *Aubrey v. Office of Attorney General*, 994 S.W.2d 516, 519 (Ky. App. 1998). As no factual dispute was presented to the circuit court below, this Court shall review this matter *de novo*.

We begin by noting that the circuit court applied an incorrect standard in disposing of the issues presented in this case. In reliance upon *Delta Air Lines, Inc. v. Commonwealth of Kentucky, Revenue Cabinet*, 689 S.W.2d 14 (Ky. 1985), the lower court held that, where tax disputes are concerned, "the burden is on the party claiming an exemption to demonstrate its entitlement to the exemption and that they have met all statutory requirements; exemptions from taxation are generally disfavored and all doubts are resolved against an exemption." However, the primary issue on appeal does not concern whether an "exemption" from taxation applied to appellant. Rather, the question is whether the monies at issue constitute income under applicable statutory and constitutional law. Because the interpretation of revenue laws drives the analysis in this matter – contrary to the circuit court's conclusion – all doubts are to be resolved in favor of the taxpayer. *See, e.g.*, *Appalachian Racing, LLC v. Family Tr. Found. of Kentucky, Inc.*, 423 S.W.3d 726, 741 (Ky. 2014) (quoting *City of Erlanger v. KSL Realty Corp.*, 819 S.W.2d 707, 709 (Ky. 1991) ("Kentucky requires that all such laws must be strictly construed with doubts concerning irregularity of the ordinance resolved in favor of the taxpayer.")). Thus, it is upon this basis that the claims at issue must be analyzed.

Ridge's first argument on appeal concerns the application of Kentucky Revised Statutes ("KRS") 141.020(4).[1] That statute provides, in pertinent part, as follows:

> An annual tax shall be paid for each taxable year as specified in this section upon the entire net income except as herein provided, from . . . business, trade, profession, occupation, or other activities carried on in this state, by natural persons not residents of this state. A nonresident individual shall be taxable only upon the amount of income received by the individual from labor performed, business done, or other activities in this state[.]

Ridge argues that the language contained in this statute limits its application in regard to nonresident taxation to instances in which income was received as a result of "activity" within the Commonwealth during the taxable year. In other words, Ridge maintains that, in order to levy a tax on a nonresident's income, "activity" must have been performed within the state of Kentucky during that taxable year.

We disagree with the appellant. At its most basic, and by its express terms, the statute requires simply that an annual tax be paid for each taxable year. The statute does not, as a threshold matter, necessarily require any affirmative act.

[1] Much of the statutory authority analyzed in this opinion has since been amended by the legislature. This resulted in new statute numbers for a law then in existence that were not modified. For purposes of disposing of the issue on appeal, we will look to those versions in effect at the time of the controversy in question. Regardless, the substantive information contained within the statutes herein quoted have remained the same, notwithstanding the legislative modifications.

As noted by the appellee, "activities" within this Commonwealth are but one purpose upon which income may be taxed. The statute clearly delineates two other purposes for which income may be taxed – "labor performed" and "business done."

In the same vein, Ridge asserts that the monies paid per the separation agreement were in exchange for his promises of "non-activity" or "forbearance." In other words, Ridge contends that the consideration Fruit of the Loom received under the contract was his agreement to *not* engage in particular types of activity, such as his covenant not to compete and promise not to make disparaging remarks about the company. Ridge's argument is that since, in his view, KRS 141.020(4) captures only types of "positive activity" or some sort of affirmative act, and because he specifically engaged in non-activity, the monies at issue lie outside the scope of the statute.

We are persuaded by *United States v. Quality Stores, Inc.*, 572 U.S. 141, 134 S.Ct. 1395, 188 L.Ed.2d 413 (2014), to the contrary. There, the United States Supreme Court held that severance payments constitute "wages" for purposes of income-tax withholding. Specifically, the Court held that "[s]everance payments are not exempted [from the statutory definition of wages], and they squarely fall within the broad textual definition of wages for purposes of income-tax withholding under [the Internal Revenue Code.]" *Quality Stores*, 572 U.S. at

150, 134 S.Ct. at 1402. The Court reached this conclusion "for the same reasons" it concluded that severance payments constituted taxable wages under the Federal Insurance Contributions Act ("FICA"). It is worth reproducing the Court's rationale in that regard here:

> [A]s a matter of plain meaning, severance payments made to terminated employees are "remuneration for employment." Severance payments are, of course, "remuneration," and common sense dictates that employees receive the payments "for employment." Severance payments are made to employees only. It would be contrary to common usage to describe as a severance payment remuneration provided to someone who has not worked for the employer. Severance payments are made in consideration for employment – for a "service . . . performed" by "an employee for the person employing him," per FICA"s definition of the term "employment."

Id. at 146, 134 S.Ct. at 1399-1400. Here, the appellant himself concedes that the amounts paid to him under the separation agreement were classifiable as "wages" and did not dispute that federal taxes were owed.

KRS 141.010(9)[2] defines "gross income" to mean as it is "defined in Section 61 of the Internal Revenue Code." Section 61 of the Internal Revenue Code, in turn, defines "gross income" as "all income from whatever source derived[.]" Thus, Kentucky law defines "gross income" in a manner consistent with the definition set forth by the Internal Revenue Code. Because the Supreme

[2] Now KRS 141.010(13).

Court has interpreted "severance pay" to qualify as "wages," and because wages incontrovertibly constitute income under both Kentucky statutory law and federal income-tax law, the severance pay at issue was clearly taxable as income from wages.

Even if we were to agree that the amount provided to the appellant pursuant to the agreement were for his promise to forego engaging in certain activities and not income from wages, we would nonetheless find that the appellant's "non-activity" falls under the purview of "labor performed" or "business done" under the statute. First, KRS 141.010(25)(f)[3] clearly provides that the phrase "[d]oing business in this state" includes, but is not limited to, "[d]eriving income from or attributable to sources within this state[.]" As the appellee points out, Fruit of the Loom is a Kentucky-based company, and all severance payments received by Ridge originated from Fruit of the Loom's Bowling Green, Kentucky headquarters. Furthermore, the formation of the agreement itself – which was signed by both the appellant and the Vice President of Human Resources for Fruit of the Loom – clearly constitutes "doing business" under the applicable statutes. Applying the plain meaning of the statutory terms to this set of factual circumstances can lead us to no other conclusion than that Ridge "derived income from or attributable to sources within this state," that he therefore

[3] Now KRS 141.010(7)(f).

was "doing business" in the Commonwealth, and that, pursuant to KRS 141.020(4), he was therefore properly assessed a tax in Kentucky.

Furthermore, the benefits afforded the appellant under the separation agreement were clearly for "labor performed" in the Commonwealth of Kentucky. Fruit of the Loom's payment under the agreement was in recognition of the appellant's *past* "labor performed" – that is, the appellant's previous ten years' of service. Although appellant emphasizes that the monies supplied to appellant per the separation agreement were not for past work performed, but, rather, in exchange for appellant's forfeiture of certain rights, it is hard to imagine that Fruit of the Loom would have agreed to pay the appellant nearly $85,000 had it not been for the appellant's lengthy record of service to the company. It would not have paid him those monies if he had not worked for Fruit of the Loom in Bowling Green, Kentucky. Hence, Kentucky can tax the income per statute.

Beyond his arguments of statutory interpretation, Ridge asserts that the taxation of severance pay at issue here is unconstitutional because taxation must bear some physical relation to protection and opportunities given by the state. Specifically, the appellant contends that "[t]axation of a non[-]resident in the absence of taxpayer activity within the state fails the 'broad inquiry'" test contained in the United States Supreme Court decision of *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 128 S.Ct. 1498, 170 L.Ed.2d

404 (2008). In that case, the Supreme Court held that the "Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation." *Id.* at 24, 128 S.Ct. at 1505 (citations omitted). "The 'broad inquiry' subsumed in both constitutional requirements [the Commerce Clause and the Due Process Clause] is 'whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state' – that is, 'whether the state has given anything for which it can ask return.'" *Id.* at 24-25, 128 S.Ct. at 1505 (citations omitted). "The Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation." *Id.* at 24, 128 S.Ct. at 1505 (citations omitted). Also, the Due Process Clause demands that there exists "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," as well as a rational relationship between the tax and the values connected with the taxing state. *Quill Corp. v. North Dakota By & Through Heitkamp*, 504 U.S. 298, 305-06, 112 S.Ct. 1904, 1909-10, 119 L.Ed. 2d 91 (1992), *overruled on other grounds by South Dakota v. Wayfair, Inc.*, __ U.S. __, 138 S.Ct. 2080, 201 L.Ed.2d 403 (2018).

Because, Ridge argues, the separation agreement constitutes a quid pro quo for non-activity, and because the non-activity has no definite relationship

with the Commonwealth, the taxation at issue here fails the "broad inquiry" of "whether the state has given anything for which it can ask a return." Essentially, the appellant argues that the separation agreement at issue contemplates payment in exchange for agreement not to engage in some affirmative act – that is, his agreement *not* to work, among other things. Since he exercised forbearance from continuing to work in the Commonwealth, Ridge contends that Kentucky cannot impose a tax on monies paid to him by his employer.

We first note that the collection of tax on Ridge's payments did not discriminate against interstate commerce. On its face, the law requires only that a tax be levied on income received by an individual non-resident from labor performed, business done, or other activities *within the state*. Nor can we say that the law discriminates in effect. As is evidenced by the record, Ridge was not subjected to multiple or unfairly apportioned taxation. Rather, Ridge was assessed a tax on the monies only by one entity – the Commonwealth of Kentucky. The appellant was taxed in the same manner as any resident in the Commonwealth of Kentucky. A portion of his wages were withheld in compliance with the pertinent statutes by his employer, a business which was operated and located in the Commonwealth of Kentucky.

Ridge's constitutional argument seems to be that the taxation at issue here did not bear some physical relation to protection and opportunities given by

the Commonwealth during taxable year 2016. Hence, Kentucky is forbidden from imposing a tax based on benefits provided by the Commonwealth in the past. We can find nothing in Kentucky statutory authority nor federal case law that so holds. Furthermore, as alluded to previously, we are convinced that the *Quality Stores* case sets forth definitive precedent on this issue. As explained in greater detail above, severance pay constitutes "wages" under the Internal Revenue Code (and therefore, by operation of KRS 141.010(9), under Kentucky statutory authority, as well), and is thus income pursuant to Chapter 140 of the Kentucky Revised Statutes. The ability to earn that income was based on Ridge's employment in the Commonwealth. For example, during his employment Ridge had received protection of law enforcement, an opportunity to be employed, and the benefits of the road system, all from or derived in the Commonwealth. The Commonwealth has the authority to tax the income so derived from his employment in the state.

Therefore, the income from this severance agreement was taxable pursuant to KRS 141.020(4) and its application to appellant was not unconstitutional. The judgment of the Franklin Circuit Court is AFFIRMED.

ALL CONCUR.

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