

# Kentucky unitary and consolidated returns



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*Is it true that there are no new ideas, only rediscoveries? The 2018 Kentucky General Assembly rediscovered both unitary combined reporting and elective consolidated reporting. As a notable aside, the General Assembly also effectively lowered the corporate rate to a flat 5 percent, updated the Internal Revenue Code reference date to conform to the 2017 Tax Cuts and Jobs Act (with the notable exceptions of depreciation and the qualified business income deduction), replaced the double-weighted sales three factor apportionment formula with a single sales factor (exceptions for communications, cable and internet access businesses) and adopted market based sourcing; these changes went into effect for tax years beginning on Jan. 1, 2018. Back to unitary and consolidated reporting, effective for tax years beginning on or after Jan. 1, 2019, a corporate taxpayer doing business in the Commonwealth that is a member of a unitary group must determine its corporation income tax using the unitary combined reporting method, unless the corporate group makes an election to file consolidated with its affiliated group under the Internal Revenue Code of 1986, as amended.*

*“The Matrix...is the world that has been pulled over your eyes....”  
Morpheus in The Matrix (1999) -  
Unitary Ban Lifted*

*Going back to basics for a moment, what state consolidated reporting is would seem to be relatively straightforward, i.e., computing income on the same basis as the federal consolidated income tax return and apportioning and allocating the income thereof as though it were a single corporation. Unitary reporting is computing income by combining the income of the businesses that make up an economic business unit and then apportioning and allocating the income of the unitary group in accordance with the state’s rules.*

*From a historical perspective, this new methodology is curious. From the mid-1990s until 2005, when the General Assembly put the mandatory nexus consolidated return provisions into place, corporations could elect to file a consolidated return. And prior to that, the Kentucky Department of Revenue could require, or corporations could attempt to compute, their income using unitary combined reporting. For a history of unitary combined reporting in Kentucky, read *GTE v. Revenue Cabinet*, 889 S.W.2d 788 (Ky. 1994). Notably, the General Assembly outlawed unitary combined reporting and refunds using that methodology, which was discussed in *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009). While elective consolidated has been previously embraced and mandatory nexus consolidated reporting is somewhat unique to Kentucky, it is somewhat surprising that the 2018 General Assembly passed the unitary method given the history.*

*“What are you waiting for?”  
Morpheus - No Guidance Yet*

*Obviously, the Kentucky Department of Revenue (DOR) has not had enough time to promulgate proposed regulations or issue other guidance. So, we do not know how the DOR will interpret the mechanics of these filing methods. The following are simply prognostications.*

*“[T]here’s a difference between knowing the path and walking the path.”  
Morpheus - Unitary  
Combined Required, Unless  
Consolidated Elected*

*A corporate taxpayer doing business in Kentucky that is engaged in a unitary business with one or more other corporations is required to file a unitary combined report. See 2018 Ky. Acts c. 207, § 120(3)(a). However, such a corporation, which is included in an affiliated group for federal income tax purposes, that has elected to file a consolidated return for*

Kentucky income tax purposes does not have to report its income under the unitary method. *See* 2018 Ky. Acts c. 207, § 119(3). A consolidated return election is binding for 96 months, roughly eight years. *See* 2018 Ky. Acts c. 207, § 119(4). Other corporate taxpayers may file a separate company return. *See* 2018 Ky. Acts c. 207, § 119(3)(c).

As a logical consequence, the mandatory nexus consolidated reporting will no longer be a filing methodology. One could wonder whether or not a corporate taxpayer could make the argument that it could continue using the mandatory nexus consolidated reporting under the alternative apportionment rules?

*“You are the  
One....” Morpheus  
– Single Return,  
Whether Unitary or  
Consolidated*

One commonality between unitary combined and elective consolidated methods is that in either case, only a single tax return is filed. *See* 2018 Ky. Acts c. 207, §§ 119 & 120. At least both methods cut down on the number of the returns.

*“There is no  
spoon.” Spoon  
Boy - Composition  
of Unitary and  
Consolidated Groups*

A unitary group, *i.e.*, a unitary business, may be comprised of parts of a single corporation or commonly controlled corporations that are sufficiently interdependent, integrated and interrelated through their activities providing a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. *See* 2018 Ky. Acts c. 207, § 120(2)(f)&(3). This is essentially the same definition of a unitary business found in Multistate Tax Commission (“MTC”) Regulation IV.1.(b)(1).

A unitary group, in addition to U.S. domestic corporations, also includes: any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the apportionable income of other members of the combined group; any member doing business in a tax haven; income from a pass through entity. *See* 2018 Ky. Acts c. 207, § 120(8).

The classically unitary business is a vertically integrated business, such as a business in which a manufacturer produces an item that it sells (or transfers) to a distributor which in turn sells (or transfers) the item to a retailer. *See also, e.g., Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983). However, a unitary business may also be a

horizontally integrated business which could be, for example, a group of retail stores, although being in the same line of business does not necessarily mean that corporations are unitary. *See, e.g., F. W. Woolworth Co. v. Taxation & Revenue Dep’t of State of N. M.*, 458 U.S. 354 (1982).

Obviously, determining the composition of a unitary group of corporations can be difficult, since it is a determination based on the particular facts and circumstances of corporations under common control. Different states may come to different conclusions. Doesn’t it seem like unitary can be in the eye of the beholder? There may be multiple unitary groups within a federal consolidated return group, and a unitary group could conceivably include corporations outside of the group.

The composition of the consolidated group is the same as the federal affiliated group that files or would file a consolidated return for federal income tax purposes. *See* 2018 Ky. Acts c. 207, § 119(2)&(4). This is pretty straightforward by comparison to determining the composition of a unitary group.

*“You take the blue  
pill [or] the red  
pill....” Morpheus -  
Consolidated versus  
Unitary Taxable  
Income*

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## Returns continued

A consolidated group is treated for all purposes as a single corporation. *See* 2018 Ky. Acts c. 207, § 119(4)(a). So, the computation of the consolidated group's Kentucky taxable income is relatively straightforward: the consolidated group's federal taxable income adjusted for Kentucky differences less any allocable income is multiplied by the consolidated group's apportionment factor, and then any allocable income (or loss) is added (or subtracted) therefrom. *See* 2018 Ky. Acts c. 207, §§ 53, 56 & 60.

A unitary group is not treated like a single corporation; rather, the Kentucky taxable income of each corporation in a unitary group is computed on a by-taxpayer basis: the unitary group's federal taxable income adjusted for Kentucky differences less any allocable income is multiplied by the single sales factor apportionment factor, the number of which is each taxpayer's sales and the denominator of which is the unitary group's total sales. *See* 2018 Ky. Acts c. 207, § 120(6)&(7). Each taxpayer's income is comprised of: the income from each unitary group of which it is a member (which assumes that a corporation – or presumably a part thereof – may be a member of more than one unitary group); income from distinct business

activities; income from a business wholly in Kentucky; income from the certain capital asset sales and involuntary conversions; nonapportionable income allocated to Kentucky and net operating loss carryovers. *See* 2018 Ky. Acts c. 207, § 120(5)(a). There is particular treatment prescribed for charitable expenses as well. *See* 2018 Ky. Acts c. 207, § 120(8)(f).

Several questions arise in the context of computing the taxable income of unitary groups. For example, there are statutory provisions for the deferral of intercompany expenses. 2018 Ky. Acts c. 207, § 120(8)(e). So, would it seem that intercompany expenses are eliminated? What about the exceptions to the disallowance provided for by KRS 141.205 of certain deductions for certain intangible expenses, management fees and certain other expenses paid to related parties? Another issue is how the protections of P.L. 86-272 will be applied.

Since a consolidated group is treated like a single taxpayer for all purposes, these same issues would not appear to similarly manifest themselves.

*“You all look  
the same to me.”  
Morpheus - Net  
Operating Losses*

Under mandatory nexus consolidated reporting, net operating losses and carryovers are computed on a pre-apportionment basis. *See generally* 2018 Ky. Acts c. 207, § 79 (KRS 141.200). In switching from mandatory nexus consolidated reporting to either consolidated reporting or unitary reporting, issues can be anticipated to arise with regard to net operating loss carryforwards. Does section 120(5)(a) require the computation of net operating losses under unitary reporting to be made on a post-apportionment basis? Does section 119 require the computation of net operating losses under consolidated reporting to be made on a post-apportionment basis? Will the DOR use the same logic as in the net operating loss regulation, 103 KAR 16:250, that applied to the prior iteration of elective consolidated returns?

*“Help!, need a little  
help!” Neo –Tax  
Credits*

The tax credits of one unitary group member cannot offset the tax of another member. *See* 2018 Ky. Acts c. 207, § 120(5)(b). But since a consolidated group is treated for all purposes as a single corporation, tax credits from one corporation may offset the liability of the consolidated group. *See* 2018 Ky. Acts c. 207, § 119(4)(a). Corporate groups

with tax credits residing in corporations different from the corporations generating Kentucky taxable income may be well incentivized to elect to file a consolidated return.

*“After this, there is no turning back.” Morpheus – Criticisms of Unitary Reporting*

A group of taxpayers and organizations representing business have criticized mandatory unitary combined reporting. They argue most of Kentucky’s neighboring states do not have mandatory unitary reporting which puts Kentucky at a competitive disadvantage; the determination of what companies constitute a unitary group has been the subject of prolonged

litigation in several states. Mandatory unitary reporting does not necessarily result in increased revenue. They seek to make unitary reporting elective.

That the approach to unitary reporting chosen by Kentucky has received criticism is not surprising. There was no study done, and the methodology was not vetted.

Assuming that Kentucky is going to continue down the path of becoming a unitary reporting state, should the General Assembly not consider some suggestions to ensure that Kentucky is not an outlier? If kept, shouldn’t Kentucky’s unitary reporting scheme be tweaked to make it more mainstream? What about making unitary reporting elective? What about allowing a phase-out of mandatory nexus consolidated

reporting? Maybe as a 96-month election?

*“A déjà vu is usually a glitch in the Matrix. It happens when they change something.” Trinity in The Matrix (1999).*

Unitary combined reporting? Elective consolidated reporting? They are coming back, unless the General Assembly changes its mind and repeals them or tweaks them. Shouldn’t we start evaluating the options and start planning?

Do you have questions? Loyd will be part of a tax update panel during the Business and Industry Conference on Sept. 27-28.

See more information regarding the conference on page 30 and register at [kycpa.org](http://kycpa.org).

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