taxnotes®

state & local

Volume 89, Number 3 ■ July 16, 2018

The Unitary Filing Method in Kentucky — The Lazarus Effect

by Mark F. Sommer and Ryan M. Gallagher

Reprinted from *State Tax Notes*, July 16, 2018, p. 223

The Unitary Filing Method in Kentucky — The Lazarus Effect

by Mark F. Sommer and Ryan M. Gallagher

Mark F. Sommer

Ryan M. Gallagher

Mark F. Sommer is a member and Tax, Employee Benefits and Estates Practice Group leader, and Ryan M. Gallagher is a summer associate with Frost Brown Todd LLC in Louisville, Kentucky.

In this viewpoint, the authors discuss the unitary filing method in Kentucky, including its statutory origins and how things stand following the unitary doctrine's resurrection.

On the last day of the 2018 session, without any prior announcement, the Kentucky legislature approved the most significant change to the commonwealth's tax code and structure in nearly a century.[1] After spending decades considering tax reform, proposals addressing Kentucky's poorly funded pension system, and tight budgets, Frankfort finally passed some form of tax reform — albeit obtusely.[2] The bill looks to raise revenue through various tax cuts and increases,[3] including significant raises to the cigarette tax,[4] changes to the income tax rate structure,[5] and new sales taxes on various services.[6] One independent tax policy nonprofit estimates that H.B. 487 would raise up to an additional $487 million for the commonwealth.[7]

The most significant change in H.B. 487 is the commonwealth's return to the unitary filing method (commonly referred to as mandatory combined reporting) for corporations.[8] This change will affect many taxpayers, as it "will significantly broaden the corporate tax base in" and capture otherwise lost taxes from "many businesses that were able to 'structure' their way out of Kentucky's corporate income tax grasp."[9]

For tax years on or after January 1, 2019, multi-entity corporate families must change their filing method to one of two combined methods from the 2005 enacted nexus-only-

[1] Daniel Mudd, "Guest Post: Kentucky Tax Reform—Big Changes for the Business Community," Greater Louisville Inc. (May 22, 2018).

[2] *See id.* (noting that the legislature drafted, considered, argued, and passed Kentucky H.B. 487 over a 48-hour period); Morgan Scarboro, "Kentucky Legislature Overrides Governor's Veto to Pass Tax Reform Package," Tax Foundation (Apr. 16, 2018) (remarking that "the final passage of H.B. 366 has been a multistep process that resulted in some unlikely political coalitions" and later noting that the Republican-controlled legislature overrode the GOP governor's veto of the reform).

[3] *See generally* Daniel Desrochers and Linda Blackford, "Taking Your Dog or Cat to the Vet Would Be Taxed. Here's What Else Is in the GOP Plan," *Lexington Herald-Leader: Politics & Government*, Apr. 3, 2018; Tom Loftus, "What You Need to Know About the Kentucky Tax Reform Bill," *The Courier-Journal*, Apr. 15, 2018.

[4] H.B. 487, 2018 General Assembly, regular session, section 27, 2018 Ky. Laws 207 (raising the cigarette tax from 56 cents per pack to $1.06 per pack).

[5] *Id.* at section 57 (changing the income tax structure from a scaling rate of 2 percent to 6 percent, depending on the taxpayer's level of income, to a flat 5 percent rate).

[6] *Id.* at section 37(2)(g)-(q) (requiring sales taxes on some services rendered — including landscaping, small animal veterinary services, pet care services, dry cleaning, and tanning salons).

[7] Jared Walczak, "Updated Kentucky Tax Reform Package Would Boost State from 33rd to 18th on the State Business Tax Climate Index (Updated)," Tax Foundation (Apr. 2, 2018).

[8] *Id.* at sections 60, 79.

[9] Mark F. Sommer, "Tax Reform in Kentucky: What It Means for You," KY. Chamber News (Kentucky Chamber of Commerce, Frankfort, Ky.) (May 2018) at 2; *see also* Mudd, *supra* note 1 ("This change will significantly broaden the corporate tax base in Kentucky, and with it bring into Kentucky's tax base many businesses which were previously able to 'structure' themselves out of Kentucky's corporate income tax.").

based consolidation structure — which looked to the percentage of direct ownership in an affiliated corporation and whether there is a sufficient nexus regarding the commonwealth.[10] Unitary is alive again, as is the elective U.S. Affiliated Group filing method. This is the first time since 1996 that the unitary filing method has been available to or required of corporations. Unitary has, à la Lazarus, risen. With that lengthy gap and long history in mind, this article explores the background of the unitary filing method in Kentucky, its statutory origins, and the state of affairs following the unitary doctrine's resurrection.

I. Background

The unitary doctrine attempts to address the problem posed by multi-entity, multistate corporations: How can one "delegate a fair portion of the value of a business to a single jurisdiction when that business conducts its activities in a number of jurisdictions"?[11] Historically, before deciding whether to require an alternative apportionment method — one deviating from the statutory requirements — Kentucky generally attempted to "properly apportion [a] portion of a corporate taxpayer's income that may be taxed under the three-factor formula of sales, property, and payroll."[12] Then, if that apportionment did not fairly represent a company's business in Kentucky, one would look to, *inter alia*, the unitary method as an alternative.[13] Today, with the benefit of several U.S. Supreme Court cases regarding the unitary business concept,[14] states treat the unitary filing method as a starting point for the tax base and its apportionment rather than as an alternative.[15] In fact, more than half of the states that impose a corporate income tax use the unitary filing method[16] — movement that illustrates how tax treatment, policy, and jurisprudence can dramatically shift over generations.[17]

A. Unitary Filing: Constitutional Bases

Declared by the Supreme Court as "the linchpin of apportionability in the field of state income taxation,"[18] the unitary business concept has been alive in tax law for more than 90 years.[19] Broadly, there is a "bedrock constitutional principle that a state may not tax activities with which it lacks a concrete connection."[20] While that exercise may often be simple when a state taxes an individual or a corporation domiciled in that state, "it is often difficult . . . for a state to determine . . . the amount of income attributable to a multistate or multinational corporation's in-state activities."[21] The unitary business doctrine attempts to obviate or lessen that difficulty. As Walter Hellerstein noted in the seminal guide, *State Taxation*:

> Under the unitary business principle, if a taxpayer is carrying on a single "unitary" business within and without a state, the state has the requisite connection to the out-of-state activities of the business to justify inclusion in the taxpayer's apportionable tax base of all of the property, income, or receipts attributable to the combined effect of the out-of-state and in-state activities.[22]

Originally, states applied the unitary business principle in the 19th century to railroad, telegraph, and express companies — as those industries typically led to collective, coordinated activities

[10] Sommer, *supra* note 9, at 2; Mudd, *supra* note 1.

[11] Robert P. Mohan, "The Unitary Concept Today," 5 *Journal of State Taxation* 57, 57 (1986); *see also* Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, para. 8.07[1] (2018).

[12] Sommer, "The Unitary Filing Method in Kentucky: Dead or Alive?" 10 *Journal of State Taxation* 59, 60 (1991).

[13] *Id.*

[14] *See infra* Part I.A.

[15] *See infra* Part I.B.

[16] "Combined Reporting of State Corporate Income Taxes: A Primer," Institute on Taxation & Economic Policy (Feb. 24, 2017) (noting that 25 states and the District of Columbia have adopted combined reporting as of February 2017). With H.B. 487, the number of states that have adopted combined reporting is now 26 states plus the District of Columbia.

[17] *Compare infra* Part I.A, *with* Sommer, *supra* note 12, at 60.

[18] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980).

[19] *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 320 n. 14 (1982) (declaring that the unitary business concept had "been a familiar concept in our tax cases for over sixty years" in 1982).

[20] Hellerstein and Hellerstein, *State Taxation*, para. 8.07[1] (2018).

[21] *Id.*

[22] *Id.*

within a company or group of companies across state lines.[23] The Court upheld this practice, noting that "a railroad must be regarded for many, indeed for most purposes, as a [single] unit."[24] Over time, the Court began to uphold states' use of the unitary business principle for companies that manufactured a product in one jurisdiction but sold it in another.[25] The problem then, as it often is now, was the determination of what companies qualified as a unitary business. In subsequent cases, "the Court described a unitary business as one characterized by 'functional integration, centralization of management, and economies of scale.'"[26] Further, that unitary business must be concretely related to in-state activities and there must be "some sharing or exchange of value" among the related companies.[27]

Starting with *Mobil Oil Co. v. Commissioner of Taxes*, the Court's most recent cases have reiterated the three baseline characterizations of unitary businesses — functional integration, centralization of management, and economies of scale[28] — and states have attempted to codify or modify this standard in their tax codes.[29]

The Court has authorized those attempts at modification, making it clear that "there is a wide range of constitutionally acceptable variations on the unitary business theme."[30] For example, the Court has used the three unities test[31] and the "substantial mutual interdependence" concept[32] in addition to the *Mobil* criteria when upholding unitary filing schemes. Although states can define the scope of a unitary business, "and surely may adopt a narrower view of the unitary business than that authorized by [the] Court['s] decisions, their freedom to expand the scope of the unitary business concept is limited."[33] In other words, *Mobil*'s three-factor criteria serves as the limit on the states' ability to expand the unitary business concept. But in Kentucky, the law has stated clearly for more than 20 years, no unitary filings — period. Was Kentucky thumbing its nose to the U.S. Constitution?

B. Kentucky's 2018 Tax Reform

Before the 1996 abolition of the unitary filing method, Kentucky case law typically analyzed it as within "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."[34] The question often was which companies are separate and which are unitary?[35] Today, H.B. 487 brings Kentucky into the light and properly treats the unitary filing method as a starting point for base determination and apportionment while also attempting to answer questions surrounding the qualification and identification of unitary businesses.

At first glance, the legislature seems to leave to the courts and the Department of Revenue the issue of who qualifies for collective group reporting under the statute's broad definition. Thankfully, unlike the past, Kentucky's tax reform includes a definition for unitary businesses:

> "Unitary business" means a single economic enterprise that is made up either of separate parts of a single corporation or of a commonly controlled group of

[23] *See id.* (citing Elcanon Isaacs, "The Unit Rule," 35 *Yale L. J.* 838 (1926)).

[24] *State Railroad Tax Cases*, 92 U.S. 575, 608 (1875); Hellerstein and Hellerstein, *State Taxation*, para. 8.07[1] (2018).

[25] *See* Hellerstein and Hellerstein, *State Taxation*, para. 8.07[1] (2018) (describing manufacturing and sales cases, including *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924), in which the Court upheld the imposition of unitary tax on an ale company that manufactured in England but sold in New York).

[26] Hellerstein and Hellerstein, *State Taxation*, para. 8.07[1] (2018) (citing *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 166 (1983)).

[27] *Container*, 463 U.S. at 166.

[28] *See* Hellerstein and Hellerstein, *State Taxation*, para. 8.07[3][a][i] (2018) (pointing to *Mobil*, *Exxon*, *ASARCO*, *Woolworth*, *Container Corp.*, *Allied-Signal*, and *MeadWestvaco* as examples of the Court using functional integration, centralization of management, and economies of scale as the criteria of a unitary business).

[29] *See infra* parts II-III; *see generally* Hellerstein and Hellerstein, *State Taxation*, para. 8.09 (2018).

[30] *Container*, 463 U.S. at 178 n. 17; *see also* Michael Aikins, Note, "Common Control and the Delineation of the Taxable Entity," 121 *Yale L.J.* 624, 638 ns. 40-41 (2011) (describing various tests for unitary businesses created by commentators and state courts).

[31] *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).

[32] *F.W. Woolworth Co. v. Taxation and Revenue Department*, 458 U.S. 354 (1982).

[33] Hellerstein and Hellerstein, *State Taxation*, para. 8.07[3][a][vii] (2018).

[34] Sommer, *supra* note 12, at 60; *see also* H.B. 487, 2018 General Assembly, regular session, section 60(12)(a)(3), 2018 Ky. Laws 207.

[35] *See* Frank M. Keesling and John S. Warren, "The Unitary Concept in the Allocation of Income," 12 *Hastings L.J.* 42, 45-46 (1960) (noting that the distinction between separate and unitary businesses "lies solely in the difference in the relationship of various businesses to the taxing jurisdiction").

> corporations that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide 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. For purposes of this section, the term "unitary business" shall be broadly construed, to the extent permitted by the United States Constitution.[36]

A definition of unitary business or unitary group does not appear in any prior version of Kentucky's tax code. That is likely a major change for how the commonwealth's courts will determine who qualifies as a unitary business going forward.

At least two other states, Oregon and West Virginia, have adopted substantially similar definitions for mandatory combined unitary reporting. Section 317.705 of the Oregon Revised Statutes defines a unitary business as a group of corporations engaged in a "business enterprise in which there exists directly or indirectly between the members . . . a *sharing or exchange of value* as demonstrated by [centralized management, centralized administration resulting in economies of scale, or functional integration]."[37] The West Virginia State Tax Commission's definition of unitary business in rule 110-24-13a is almost identical to the one in Kentucky H.B. 487.[38]

Commentators argue that a broader definition for combination is more favorable than a narrow definition — such as Kentucky's previous narrow "nexus" combined definition — because "any tightly structured definition would have broad implications for issues not yet raised."[39] In other words, a court that makes periodic determinations based on fairness and equity is better suited to face the challenge posed by accurately capturing taxes from groups of affiliated taxpayers on a case-by-case determination, than one attempting to solve every problem prospectively by declaration, definitions, and bright-line rules. To that end, declarations, definitions, and bright-line rules allow some potential taxpayers to avoid Kentucky's nexus-consolidated reporting by structuring around the rules.[40]

Before the 2018 tax reform, the definition for who had to file a separate Kentucky return and who had to file a mandatory consolidated return was statutorily determined; one looked to whether groups fell within the "nexus" definition. First, the DOR could only require reporting from businesses that are doing business in the state,[41] which includes having a Kentucky commercial domicile, offering services in Kentucky, and directing activities at Kentucky customers to sell them goods and services.[42] Then the question was whether that entity was within the defined affiliated group — whether there was a direct, statutorily sufficient link between the parent company and the involved subsidiary. Under the nexus determination, two companies were affiliated only if the parent company directly owned at least 80 percent of the stock and voting power in the subsidiary.[43] In sum, the two companies would have to file a consolidated return in Kentucky if both did business in the commonwealth and if the parent company owned at least 80 percent of the subsidiary.

When it was permissible more than a generation ago, the unitary filing doctrine provided a much broader — albeit judicially determined — definition of affiliation. Now, a court and the DOR must look to whether a group falls within the statutory definition of a unitary business,[44] which lists things for the department and courts to look to but does not

[36] H.B. 487, 2018 General Assembly, regular session, section 120(2)(f), 2018 Ky. Laws 207.

[37] Or. Rev. Stat. section 317.705 (emphasis added).

[38] W.Va. Code R. section 110-24-13a.2, 13a.4 (2018). West Virginia's regulations on unitary go into great detail about what factors support a finding of a unitary business. *See, e.g.*, section 110-24-13a.6, which describes functional integration and lists 20 non-exhaustive factors to consider when determining functional integration. Kentucky Department of Revenue regulations following the adoption and codification of H.B. 487 may also look to West Virginia and thereby include the same or similar list of factors.

[39] Mohan, *supra* note 11, at 57.

[40] *See supra* note 9 and accompanying text.

[41] Ky. Rev. Stat. Ann. section 141.200(9), *amended by* H.B. 487, 2018 General Assembly, regular session, section 79, 2018 Ky. Laws 207.

[42] Ky. Rev. Stat. Ann. section 141.010(25), *repealed and reenacted by* H.B. 487, 2018 General Assembly, regular session, section 53, 2018 Ky. Laws 207.

[43] Ky. Rev. Stat. Ann. section 141.200(9)(b), *amended by* H.B. 487, 2018 General Assembly, regular session, section 79, 2018 Ky. Laws 207.

[44] *Id.* at section 120(2)(f).

create bright-line rules like the nexus method did.[45] Thankfully, the legislature did grant the DOR the authority to "promulgate administrative regulations for determining the alternative allocation and apportionment method"[46] and presumably combined filing.

Note that as an alternative to a group filing as a unitary combined group, the group can elect "to file what is known as a U.S. Affiliated Consolidated Group return, on an elected basis for eight years at a time."[47] Arguably, this lowers the burden of complying with the unitary filing method, given the common nature of this filing across the country for federal tax purposes.[48]

Even with the new statutory definition, the unitary filing method presents problems surrounding what entities are within the group of mandatory combined unitary reporting. In the past, the DOR took informal administrative actions and advanced rules that defined the groups that were within the unitary filing method.[49] Later and over time on review, Kentucky courts employed various tests for determining whether a group qualified as a unitary business, which in turn resulted in a rule that mirrored the court opinions.[50] Those rules and cases no longer controlled after lawmakers amended the tax code in 1996 to disallow use of the unitary filing method.[51]

With the resurrection of the unitary filing method by H.B. 487, it is necessary to look at Kentucky's historical case law surrounding this issue to better understand how the courts may now determine what qualifies as a unitary business, particularly given the existence of a statutory definition of "unitary" for the first time ever in Kentucky.

II. Kentucky's History of Unitary Tests

Over Kentucky's decades of "rather confusing, fact-specific trail" of case law regarding the unitary method, various qualifying tests arose.[52] Although those tests seemed to change with each case, before the legislature expressly disallowed unitary filing, the Kentucky Supreme Court was clear that the DOR had to allow the filing of unitary consolidated returns, because the tax code did not prohibit it and because the department had a long history of allowing it.[53] Here, the new statute *explicitly* requires a unitary filing if within the statutory definition — thereby forcing the DOR to promulgate new rules and publish tests for unitary filing for the first time in more than 20 years.

"Generally, in order to qualify as a unitary business, one of two tests must be satisfied, either the three unities test or the contribution or dependence test."[54] Kentucky case law, however, has applied a third test: the "sham corporation test."[55] The DOR will likely pick one of those three qualifying tests when promulgating regulations concerning the unitary business concept; thus, a discussion of each is beneficial. The Kentucky appellate courts' prior treatment of the unitary filing method may give an insight into what tests the department may adopt.

A. The Three Unities Test

Historically, most states that have adopted the Uniform Division of Income for Tax Purposes Act or signed onto the Multistate Tax

[45] *See id.*

[46] *Id.* at section 60(12)(b).

[47] Sommer, *supra* note 9, at 2; *see* H.B. 487, 2018 General Assembly, regular session, section 119(3)-(4), 2018 Ky. Laws 207 (requiring corporations that are part of a unitary business group to file combined Kentucky returns if they do not file consolidated federal returns).

[48] Sommer, *supra* note 9, at 2.

[49] *See* Sommer, *supra* note 12, at 60-65.

[50] *Id.* Note, though, that the DOR did attempt to usurp the court's qualifying test via administrative action in Revenue Policy 41P225 — but failed to continue to do so after the Kentucky Board of Tax Appeals found that policy null and void. *See id.* at 65-66.

[51] 1996 Ky. Laws 239, section 1(11) ("Nothing in this section shall be construed as allowing or requiring the filing of a combined return under the unitary business concept or a consolidated return"); *see Miller v. Johnson Controls Inc.*, 296 S.W.3d 392, 395 (Ky. 2009) (noting that the effect of the 1996 amendment "was to undo the 'unitary business concept'" and the judiciary's interpretation thereof and instead give the legislature more control over the process).

[52] Sommer, *supra* note 12, at 61.

[53] *GTE v. Revenue Cabinet*, 889 S.W.3d 788, 792 (Ky. 1994) (*citing Grantz v. Grauman*, 302 S.W.2d 364 (Ky. 1957)) (finding that the doctrine of contemporaneous construction requires an agency that is interpreting an ambiguous statute to adopt a long-standing construction of those provisions, which makes the DOR's publication of Revenue Policy 41P225 improper because it abandoned the long-standing administrative policy of allowing unitary filing).

[54] Sommer, *supra* note 12, at 60.

[55] *See id.*

Compact have used either the three unities test or the contribution or dependence test.[56]

The three unities test looks to whether the group has a unity of ownership, use, and operations.[57] While some argue that "these glib superficial phrases are at best ambiguous, if not actually meaningless,"[58] the case law arguably shows that Kentucky tribunals have preferred this definition over others. The unity of ownership is shown by the parent company owning a controlling share of the subsidiary. The unity of use is shown by "the centralized executive force and general system of operation."[59] The unity of operation is shown "by central purchasing, advertising, accounting, and management."[60] Many Kentucky cases, however, are not particularly helpful in forecasting how a court would come out on the unity issue, since the courts effectively have summarily dealt with the issue of the unities.[61]

Before the integration of the unitary business doctrine in Kentucky, its highest court applied a test akin to the three unities test when finding that a motion picture theater chain was a unitary business.[62] In *Fourth Avenue Amusement Company*, the court focused on the fact that the parent company owned all of the capital stock in the subsidiary for the "purpose of controlling the policies and operations of that company and using it as a mere adjunct agency . . . in the conduct of the unified business."[63] Since that 1942 pre-UDITPA decision, the court has oscillated between employing the three unities test and the other two tests. Nevertheless, Kentucky tribunals have used the three unities test in the most recent cases dealing with the unitary business concept.[64] Two recent cases illustrate modern treatment of the three unities test in Kentucky.

1. *Gannett Satellite Information Network Inc.*

In *Gannett Satellite Information Network Inc.*, the Kentucky Board of Tax Appeals[65] found that a group of 65 separate corporations was not unitary.[66] The case involved subsidiaries of Gannett Satellite, the Courier Journal Co., and other foreign and domestic newspaper and non-newspaper subsidiaries.[67] Kentucky required *The Courier-Journal* and its subsidiaries to file returns in Kentucky, as the vast majority of their assets and business were in Kentucky.[68]

The case, however, presented the question whether the foreign subsidiaries and other Gannett companies could file a unitary combined return with *The Courier-Journal*, even though their business was outside Kentucky (apart from their ownership of *The Courier-Journal*).[69] After trial, the board found that the companies did not have sufficient unity to warrant a unitary combined return. *The Courier-Journal*'s business operations did not "functionally integrate" with the basic business operations of any other newspaper, including non-integration of personnel and

[56] *See* Sommer, *supra* note 12, at 61 (describing that, as of 1991, the majority of Multistate Tax Commission states employed either the three unities or the contribution or dependence tests); *see also* E. George Rudolph, "The Unitary Business Concept and Affiliated Corporate Groups," 25 *Tax L. Rev.* 171, 177-80 (1970) (generally describing the Multistate Tax Compact and the impact on the adopting states); and Bill Kramer, "List of Combined Reporting States Grows," MultiState Insider (Oct. 7, 2015) (noting that, as of October 2015, 24 of the 44 states that impose corporate income tax use mandatory combined reporting for unitary businesses).

[57] *Edison Cal. Stores v. McColgan*, 183 P.2d 16, 21 (Cal. 1947); *see also GTE*, 889 S.W.3d at 791 ("The test requires a unity of ownership, use, and operations"); *Armco Inc. v. Revenue Cabinet*, 748 S.W.2d 372, 375 (Ky. 1988) (citing *Edison Cal. Stores*, 183 P.2d 16) (noting that *Edison California Stores* outlines the tests determining a unitary entity).

[58] Keesling and Warren, *supra* note 35, at 47.

[59] *Edison Cal. Stores*, 183 P.2d at 20.

[60] *Id.*; *see also Butler Bros. v. McColgan*, 315 U.S. 501, 508 (1942) (finding that "the operation of the central buying division alone demonstrates that [the unity of management is present]").

[61] *See Armco Inc.*, 748 S.W.2d at 375 (noting that *Department of Revenue v. Early & Daniel Co.*, 628 S.W.2d 630 (Ky. 1982) allows for the combination of income without discussing the unitary nature of the corporations).

[62] *Kentucky Tax Commission v. Fourth Ave. Amusement Co.*, 170 S.W.2d 42 (Ky. 1943).

[63] *Id.* at 45.

[64] *GTE*, 889 S.W.3d at 791; *Armco Inc.*, 748 S.W.2d at 395; *Publishers Printing Co. v. Finance and Administration cabinet*, Kentucky Board of Tax Appeal, para. 202-900, (Jan. 20, 2010) (using the three unities test to find that the filed unitary return did not accurately reflect the company's business activities in the state because there were no unities of operations or use); and *Gannett Satellite Information Network Inc. v. Kentucky Departmentof Revenue*, Kentucky Board of Tax Appeals, para. 202-838 (July 16, 2008) (using the three unities test to find that a unitary return could not be filed by a group of companies because there was no functional integration, unity of operations, or unity of use between them).

[65] In 2016 Kentucky consolidated the boards for general claims, Crime Victims, Claims, and Tax Appeals into a single commission called the Kentucky Claims Commission. 2017 Ky. Laws 74 *codified at* Ky. Rev. Stat. Ann. section 49.010.

[66] *Gannett Satellite Information Network Inc.*, Kentucky Board of Tax Appeals, para. 202-838 (July 16, 2008).

[67] *Id.*

[68] *Id.*

[69] *Id.*

facilities.[70] "There were no material common customers" between the various customers — specifically, advertisers who bought space in *The Courier-Journal* did not buy space in the other newspapers.[71] The companies presented no evidence that *The Courier-Journal*'s "basic business operations became mutually interdependent" of the other newspapers' operations after Gannett's acquisition.[72]

Lastly, "there was no functional integration, unity of operations, or unity of use *between* Courier Journal Co. and any Foreign Newspaper Subsidiary or Gannett Satellite."[73] Thus, the foreign newspaper subsidiaries, Gannett Satellite, and Gannett's 40 other newspapers were improperly in the unitary group at issue and were ordered to file separate returns because the unitary filing "distort[ed] the business activity conducted in Kentucky."[74]

Importantly, the board in *Gannett* noted that a parent company's management of self-contained subsidiaries (such as "administrative services, stewardship functions, and some operational involvement") cannot alone create a unitary business.[75] "Those parent-to-subsidiary relationships cannot substitute for the material economic relationships *between* subsidiaries that are a prerequisite to a finding that the subsidiaries conducted a unitary business with each other."[76] In other words, a mere connection through a parent company cannot create a unitary business; rather, there must be three unities between the subsidiaries, the parent, and the other subsidiaries. Although the parent owned the subsidiaries (thereby satisfying the unity of ownership), the board found no overall unity because the parent and other subsidiaries did not functionally integrate with the subsidiary in operation and use.

2. Publishers Printing Company

In *Publishers Printing Company*, the board found that a unitary return filed by six affiliated entities did not accurately or fairly represent the extent of the taxpayer's business in the state.[77] Each entity was organized under Kentucky law and did substantial business in the state.[78] Unlike the entities in *Gannett*, all the companies at issue participated in Publishers Printing's business.[79] Further, Publishers owned at least 95 percent of each subsidiary.[80] Each subsidiary did business in Kentucky and only one did business outside the commonwealth, hence Publishers and its subsidiaries filed a unitary return in Kentucky and Colorado.[81]

The board concluded that "all property and payroll of [Publishers]" was within Kentucky.[82] Because Publishers "escaped taxation on a substantial portion of its income" (in the amount of $13,618,941, or an estimated 40 percent of its income), "no refund may be made on the unitary return claim" as it did not fairly represent the business done in Kentucky.[83] Although Publishers had a unity of ownership, the board found that Publishers "[did] not demonstrate . . . a unity of operations, or a unity of use."[84] Like *Gannett*, the board found no integration because "the five subsidiaries exist to serve Publishers, and it does not serve them."[85] Therefore, again, to have "full integration," a group of companies must take positive actions in support of each other.

B. The Sham Corporation Test

The sham corporation theory as to unitary first appeared in *Square D Co. v. Kentucky Board of Tax Appeals*, in which Kentucky's highest court found that no unitary business existed even though the subsidiaries were engaged in related

[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*

[77] *Publishers Printing*, Kentucky Board of Tax Appeal, para. 202-900 (Jan. 20, 2010).
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*

businesses and the parent companies owned all stock of the subsidiaries.[86] In that case, Kentucky's highest court rejected application of the three unities test of *Edison California Stores* and instead looked to whether the companies' structure "is a mere sham or the subsidiaries' operations lose their independent identity by reason of exceptional integrated business relationships."[87] In other words, a group of businesses would only be a unitary business if it appeared to be trying to avoid taxes by structuring or filing in a certain way.

The court decided *Square D* before Kentucky's adoption of UDITPA in 1966.[88] However, the Kentucky Supreme Court distanced itself from *Square D* and limited its effect,[89] noting in *Corning Glass Works* that *Square D* rested on a prior statutory definition of taxable net income that only included activities within the state.[90] With the adoption of UDITPA and given the 2018 enactment of H.B. 487, all this changed, so *Square D* seems likely to not apply today. Regardless of the application of *Square D*, the DOR may still resurrect the sham theory, as it did in 1988 when it issued Revenue Policy 41P225.[91]

C. The Contribution or Dependence Test

Unlike *Publishers Printing*, in which the board found no unitary business even though the parent owned and benefited from the subsidiaries, the contribution or dependence test looks to whether "there is evidence to indicate that the operations of [a corporation's] divisions are integrated with, dependent upon, or contribute to each other and the operations of the taxpayer as a whole."[92] Some argue that "this definition is a vast improvement" on the three unities test because it "recognizes that a business, to be unitary, must be conducted partly within and partly without the taxing jurisdiction."[93] It should be noted that the board has employed both the three unities and the contribution or dependence tests at the same time[94] — which is in accordance with other modern, albeit non-Kentucky cases.[95]

As noted, in *Corning Glass Works*, Kentucky's highest court announced the state's adoption of the contribution or dependence test.[96] Corning produced more than 60,000 goods — including consumer glass, electrical, and scientific products.[97] However, "Corning's operations in Kentucky [were] relatively limited" to operation of two manufacturing plants.[98] The income at issue in the case was Corning's capital gains, and foreign royalty and interest income, which Corning argued had no connection with and were easily separate from the income generated by its Kentucky activities.[99] The Board of Tax Appeals "found that Corning commingled the income in question with its other business income and used the total income in the regular course of business."[100]

Because of this commingling, the court found that the income generated outside Kentucky fell within Corning's apportionable income.[101] The court noted that "the law no longer requires that taxable net income have an identifiable source within [Kentucky]. . . . The activities of a

[86] *Square D Co. v. Kentucky Board. of Tax Appeals*, 415 S.W.2d 594 (Ky. 1967).

[87] *Id.* at 601 (citing *Cargill Inc. v. Spaeth*, 10 N.W.2d 728 (Minn. 1943)).

[88] *See* Sommer, *supra* note 12, at 61-62.

[89] *Department of Revenue v. Early & Daniel Co.*, 628 S.W.2d 630, 632 (Ky. 1982) ("While this holding fits into the dictates of the *Square D* case . . . we think it is appropriate to note . . . that the statutory law has changed greatly since that case was decided and a source test, based on the statutes, is no longer justified"); and *Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789, 794 (Ky. 1981) ("*Square D* . . . is helpful in some way, but it essentially dealt with a statute which defined taxable net income as that which had its source from activities within Kentucky. . . . *Square D* is therefore distinguishable and is not controlling in this case").

[90] *Corning Glass Works*, 616 S.W.2d at 794.

[91] *See* Sommer, *supra* note 12, at 65.

[92] *Corning Glass Works*, 616 S.W.2d at 794.

[93] Keesling & Warren, *supra* note 35, at 48.

[94] *See Chapperal Coal Corp. v. Revenue Cabinet*, 1991 WL 101739 at *4 (Ky. Bd. Tax. App. May 2, 1991) (citations omitted). ("[Appellants] are unitary corporations because there exists unity of ownership, operation and use and because the operations of [Appellants] are dependent upon and contribute to each other").

[95] Craig B. Fields, Eva Y. Niedbala, and Michael P. Penza, "Current Developments in State and Local Tax (May 19, 2017)," 35 *Journal of State Taxation* 9, 13 (2017) (describing a California Court of Appeals case upholding a trial court unitary business determination when the trial court employed two out of three tests for unitary businesses, "stating that the U.S. Supreme Court has held that 'any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach'").

[96] *Corning Glass Works*, 616 S.W.2d at 794.

[97] *Id.* at 792.

[98] *Id.*

[99] *Id.*

[100] *Id.* at 793.

[101] *Id.* at 793-794.

corporation will be considered a single unitary business, if there is evidence" of integration, contribution, or dependence.[102] The court affirmed the board's determination that Corning did not show that the income in question did not arise from Corning's regular course of business.[103] This "regular course of business" language later appeared in a subsequent case in which the board found a stock brokerage firm with local offices in Louisville and Lexington, Kentucky was a unitary business.[104]

III. Forecasting Guidance — Which Test?

Those cases present some of the various tests that the DOR or the courts could choose from when administering or regulating the unitary business doctrine, even in the face of the new unitary statutory definition. However, in each case, the courts and department were supplied with neither a statutory definition of unitary business nor a clear legislative directive to require unitary filing as they are now. Thus, the question is whether any of the holdings apply or can contribute to the tax reform efforts, either as precedent or as a basis for regulations. One can argue that the case law still controls, or at the very least is persuasive authority for a court attempting to apply the new definition.

The new definition of a unitary business points to businesses that exist as a single economic enterprise and discusses what makes up a single economic enterprise.[105] Among those qualifications is a requirement for single ownership or control, dependence, integration, and an exchange or sharing of value among the separate parts.[106]

From that definition, it seems unlikely that a sham corporation test will exist. The word "sham" or even concept does not appear in the new definition. Further, the definition specifically references companies that may be legitimate but nevertheless unified by common ownership, control, dependence, and integration. Lastly, Kentucky courts seemed to be separating from the sham corporation test before the legislature did away with the unitary business doctrine in 1996.[107] Thus, given the new statutory language, the state seems likely to use the three unities test, the contribution or dependence test, or a combination of the two.

A combination of the two might be the best outcome for several reasons. First, the statute points to the unity of ownership by requiring a unitary business to be "separate parts of a single corporation or of a commonly controlled group of corporations."[108] Common ownership and control is plainly an element of the three unities test.[109]

Second, the unities of use and operation appear to be implicit within the inclusion of the requirements that the businesses be "interdependent, integrated, and interrelated through their activities."[110] This requirement implicates the contribution or dependence test as a set of interdependent companies are by definition dependent on each other and a set of integrated and interrelated companies contribute to each other.[111] Typically, the unity of use is shown by "the centralized executive force and general system of operation";[112] this is implicit in a single controller that integrates the parent and subsidiaries and then interrelates the companies through their activities. The unity of operation is normally shown "by central purchasing, advertising, accounting, and management."[113] The implication of the three unities test is supported by the fact that the legislature joined the requirements of interdependence, integration, and interrelation

[102] *Id.* at 794.

[103] *Id.*

[104] *Bache Halsey Stuart Shields Inc. v. Department of Revenue*, 1981 WL 14753 at *1 (Ky. Bd. Tax. App. Dec. 2, 1981).

[105] H.B. 487, 2018 General Assembly, regular session, section 120(2)(f), 2018 Ky. Laws 207.

[106] *Id.*

[107] *See GTE*, 889 S.W.3d at 792 (using the doctrine of contemporaneous construction to find a regulation requiring the use of the sham test to be null and void); *Department of Revenue v. Early & Daniel Co.*, 628 S.W.2d 630, 632 (Ky. 1982) (using other qualifying tests instead of the sham corporation theory, even though the Court pointed out that the company was created for tax-evasion purposes); and *Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789, 794 (Ky. 1981) (noting that *Square D* does not control that case because the statutes have changed).

[108] H.B. 487, 2018 General Assembly, regular session, section 120(2)(f), 2018 Ky. Laws 207.

[109] *See infra* Part II.B.

[110] H.B. 487, 2018 General Assembly, regular session, section 120(2)(f), 2018 Ky. Laws 207.

[111] *See infra* Part II.C.

[112] *Edison Cal. Stores v. McColgan*, 183 P.2d 16, 20 (Cal. 1947).

[113] *Edison Cal. Stores*, 183 P.2d at 20.

with a conjunctive — which would likely lead a court to require a showing of all three factors,[114] like the three unities. These activities seem to fall within those that integrate and interrelate the companies, as they "provide synergy and mutual benefits" to the parent and subsidiaries.[115] Therefore, the new statutory definition seems to implicate the unities of use and operation, as well as the contribution or dependence test.

Finally, the statutory definition requires something that is not explicitly in the three unities test, but that is implicit in the contribution or dependence test. The definition points to a "sharing or exchange of value among [the companies] and a significant flow of value to the separate parts."[116] This sharing or exchange of value hearkens back to *Corning*, in which the Kentucky Supreme Court found that foreign investments and income were part of a unitary business with glass manufacturing and sales in Kentucky because Corning commingled the incomes from the various sources.[117]

Thus, under Kentucky's new statutory definition of a unitary business, the courts — or the DOR via regulations — may apply a hybrid test combining the three unities and the contribution or dependence tests. This hybrid test could prove favorable to taxpayers; the inclusion of more requirements for finding a unitary business means that more businesses may be left out of the definition at the margins. And although the resurrection of the unitary business doctrine will likely broaden the tax base and force some multistate companies to file group returns in Kentucky for the first time, the legislature's measured addition of the unitary business definition — in the face of 50 years of unitary case law previously considered without such a definition — may go a ways to add clarity to a murky area of law. ■

[114] *See Department of Revenue v. Rent-A-Center Inc*, 22 Or. Tax 28, 31-33 (Or. T.C. 2015) (interpreting a prior version of the Oregon statute — current version mentioned *supra* note 37 — that looked to centralized management, centralized administration, and functional integration when determining the sharing or exchange of value as requiring the DOR to show all three factors to qualify a group as a unitary business). Oregon amended its unitary business definition to abrogate the requirement of showing all three factors in demonstrating a "sharing or exchange of value" among companies. 2007 Or. Legis. Serv. Ch. 323, section 1.

[115] H.B. 487, 2018 General Assembly, regular session, section 120(2)(f), 2018 Ky. Laws 207.

[116] *Id.*

[117] *Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789, 794 (Ky. 1981).