

March 12, 2015

The Honorable Les Donovan, Chair
Senate Tax Committee

Re: SB 260

The Kansas Society of Certified Public Accountants is NEUTRAL with reference to the passage of SB 260, concerning the taxability of "passive" income.

Specifically, Senate Bill 260 provides an exception to the general rule that losses from business enterprises are not deductible for Kansas income tax purposes as well as an exception to the general rule the income from business enterprises are not taxable for Kansas income tax purposes.

Under federal tax statute, as adopted by the state of Kansas, Passive Income is defined as **"any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate"**. If a taxpayer materially participates in the business he/she is deemed to be active in the business.

For federal income tax reporting, taxpayers must declare whether they are active or passive in the conduct every business in which they are involved and/or have an ownership interest. For tax reporting purposes, passive activities are reported on Form 8582 of the Federal income tax return. HB 2392 makes reference to Form 8582.

The federal passive activity regulations are very complex and cumbersome to understand and entail over 69 pages of content. While the passive activity provisions of the Internal Revenue Code became law in 1987, 28 years ago, they are still one of the most misunderstood and miss-applied provisions within the federal statute.

The rules for determining material participation are complex and the average Kansas taxpayer has difficulty in ascertaining for themselves whether they are active or passive. While the complexity of the passive loss rules are imposed by federal statute, this Bill further exacerbates the complexity by potentially requiring two sets of positive and negative modifications on the Kansas income tax return for Schedules C, E and F income and deductions. Accordingly, the enactment of SB 260 will bring some additional complexity to the filing of the Kansas income tax return upon the Kansas taxpayer. Much of the complexity is eased if the Kansas taxpayer engages a professional tax preparer to assist in the preparation of their income tax returns, but not all taxpayers do. SB 260 will result in the potential for numerous failures to properly comply with the statute and will increase enforcement action to effectively monitor compliance with the law.

In my conversations with various legislators during 2012 when the exemption of non-wage business income from taxation was being proposed, we discussed the issues of active vs passive and the additional complexities that were associated with differentiating between active and passive. It was universally decided at that time that the complexity was an undue burden on Kansas taxpayers.

Further, the active/passive characterization can treat the taxation of two co-owners in a business completely different. For example, assume brother and sister are equal co-owners of a Kansas small business located in Topeka. Assume the brother lives in Topeka and runs the business while the sister lives in Wichita and has no involvement in the business. Under this fact scenario, the brother's share of income from the business will be deemed to be active and not subject to Kansas income tax while the sister's share of income from the business will be passive and subject to Kansas income tax. This creates disparity between the co-owners of a business and this result was never the intention of the original legislation to exempt non-wage business income from taxation.

In the final analysis, SB 260 may raise taxes of some Kansas taxpayers due to the taxability of passive income while it may reduce the taxes of some other Kansas taxpayers due to the deductibility of passive losses. Having said that, the Kansas Society of Certified Public Accountants is **neutral** on the Bill as a whole.

Respectfully submitted,

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Chair, KSCPA Legislative Committee