Approved 1-22-87

Minutes of the House Committee on Taxation. The meeting was called to order by E. C. Rolfs, Chairman, at 9:00 a.m. on January 21, in room 519-S at the Capitol of the State of Kansas.

All members of the Committee were present except: Representatives Adam, Smith, and Wagnon (excused)

Committee Staff Present: Tom Severn, Legislative Research
Chris Courtwright, Legislative Research
Don Hayward, Revisor of Statutes
Millie Foose, Committee Secretary

The meeting was called to order by Chairman Ed C. Rolfs

Mr. Harland Priddle, Secretary of Commerce, discussed different ways income could be allocated appropriately to get the proper taxes paid.

Mr. Tom Severn explained how the tax could be divided if part of the income was received in Kansas and part in Missouri or another state. He also explained credit for payment to foreign countries (Mexico, for instance) and also explained Unitary Operations. He also explained HB-2065 (General Fund Transfers) and how this bill would freeze at the FY 1986 actual level of transfers certain demand and revenue transfers from the General Fund for the year specified. (Attachment 1)

Mr. Chris Courtright, discussed Kansas corporate income taxation of foreign dividends and gross-up. (Attachment 2) He also explained the three-factor formula income apportionment method - Kansas Corporate income tax. (Attachment 3)

There was further discussion about competition and what it would cost if our laws were changed. There was also a discussion concerning methods for bringing in more business and the federal income tax deductions.

Roger Christiansen discussed industrial development and how comparisons are reached. He said that Missouri is Kansas' toughest competition that we really do not have world-wide competition.

Mr. Harley Duncan discussed the state's current policy -- the Unitary business principle and combined reporting. (Attachment 4) He also discussed what to do with foreign dividends -- also dividends from domestic firms who also operate in foreign countries. He explained Executive Order 8791, and cited cases of how the law deals with exemptions in forty other states. He also defined "business" and "non-business" income.

There being no further business to come before the committee, the meeting was adjourned.

Ed C Rolfs

Ed C. Rolfs

Kansas Legislative Research Department January 20, 1987

MEMORANDUM

H.B. 2065 -- GENERAL FUND TRANSFERS

Shown below is a summary of the General Fund fiscal effect of H.B. 2065 pertaining to General Fund Transfers introduced by the House Appropriation Committee on January 20. The bill would freeze at the FY 1986 actual level of transfers certain demand and revenue transfers from the General Fund for the year specified.

	Millions		
	Estimated Existing Law	Proposed	Reduction
Demand Transfers			
Local Ad Valorem Tax Reduction Fund			
FY 1988	$ 31.1	$ 24.6	$ 6.5
County and City Revenue Sharing Fund			
FY 1988	22.4	18.6	3.8
Revenue Transfers			
State Highway Fund			
FY 1987	27.7	16.1	11.6
FY 1988	35.8	16.1	19.7
City and County Highway Fund*			
FY 1988	9.3	7.4	1.9
Summary			
FY 1987			$ 11.6
FY 1988			31.9
			$ 43.5

* Motor Carrier Property Tax Receipts.

2065-memo/bd

House Tax Com. - 1/21/87 - Attachment 1

KANSAS CORPORATE INCOME TAXATION OF FOREIGN DIVIDENDS AND GROSS-UP

Foreign dividends and gross-up are often a part of the federal taxable income of multinational corporations. To the extent their incomes are apportioned to Kansas, this state taxes a portion of their foreign dividends and gross-up. (K.S.A. 79-32,138(a)) Foreign dividends are simply a cash payment made from foreign subsidiaries to a U.S. parent. The gross-up arises under I.R.C.§78 when the parent elects to take a federal income tax credit for foreign income taxes related to the foreign dividends.

Example:

Assume that a U.S. parent company (P) receives $15,000 of dividends from its foreign subsidiary (FS) and that FS paid foreign taxes of $18,000 on $40,000 of income. P can take a federal tax credit for $12,273 of taxes relating to the dividend:

$$\text{Federal Tax Credit} = \frac{\text{Dividend}}{\text{FS After-tax Income}} \times \text{Foreign Taxes}$$

$$= \frac{15{,}000}{40{,}000 - 18{,}000} \times 18{,}000 = \$12{,}273$$

If P takes the tax credit, it must "gross-up" or increase its dividends by the amount of the tax credit:

FS Dividend	$15,000
Plus Gross-up	+12,273
Total Amount of Foreign Dividends and Gross-up in Federal Taxable Income	$27,273

Thus, federal and Kansas taxable income contain both foreign dividends, which are cash income to the Parent, and gross-up, which represents the proportion of foreign taxes which the dividends bear to the foreign subsidiary's after-tax income.

Sixteen states include foreign dividends in taxable income, fifteen states exempt the dividends in part and fourteen states wholly exempt foreign dividends.

THE THREE-FACTOR FORMULA INCOME APPORTIONMENT METHOD-KANSAS CORPORATE INCOME TAX

A multistate corporation must apportion or divide its taxable income among the states in which it conducts business so that each state taxes its share of the income. Kansas utilizes the equally-weighted, three-factor (property, payroll, and sales) apportionment method to apportioned such income (K.S.A. 79-3271 et seq.). Three-factor apportionment is the most widely accepted method. It has been adopted in Kansas and approximately 36 other states, principally under U.D.I.T.P.A., the Uniform Division of Income for Tax Purposes Act. (K.S.A. 79-4301 et seq. and K.S.A. 79-3271 et seq.)

Example: Corporation A does business in several states. The three-factor apportionment percentage for Kansas is determined as follows:

$$\text{Property Factor} = \frac{\text{Property in Kansas}}{\text{Total Property}} = \frac{\$1,000,000}{\$10,000,000} = 10\%$$

$$\text{Payroll Factor} = \frac{\text{Payroll in Kansas}}{\text{Total Payroll}} = \frac{\$150,000}{\$3,000,000} = 5\%$$

$$\text{Sales Factor} = \frac{\text{Sales in Kansas}}{\text{Total Sales}} = \frac{\$1,500,000}{\$10,000,000} = 15\%$$

$$\text{Average of the Three Factors} = \frac{10\% + 5\% + 15\%}{3} = 10\%$$

Ten percent of Corporation A's income is apportioned to Kansas. If its total taxable income is $1,000,000, its Kansas taxable income is $100,000.

The property, payroll, and sales factors give weight to the various factors which are responsible for earning income. They are also a good measure of state services utilized and they provide a relatively simple method of income apportionment.

Iowa is the only state which apportions income based solely on the proportion of total sales occurring in the state (although Missouri allows this as an option). Colorado allows corporations to choose the simple average of the three factors or the average of two factors, sales and property. Six states use a weighted average of the three factors: Wisconsin, New York, Massachusetts, Florida, Connecticut, and Minnesota. All of these except Minnesota weight the factors as follows: property 25%, payroll 25%, and sales 50%. Minnesota allows the option of either the three-factor simple average or apportioning using the following factor weights: property 15%, payroll 15%, and sales 70%.

THE UNITARY BUSINESS PRINCIPLE AND COMBINED REPORTING

The unitary business principle is a judicial concept dating back to the 1920's. It basically provides that for purposes of corporate income taxes when the activities of multijurisdictional corporations are interdependent and interrelated, the income generated by those activities cannot reasonably be attributed or "separately accounted" for to a particular state. The courts have consistently ruled that the appropriate method of taxing such income is to treat the income arising from the interrelated activities as a single business unit and then to divide that income among the states on the basis of an acceptable apportionment formula. The unitary business principle may be applied to one company or to a group of interrelated companies. The Kansas Supreme Court on three occasions - Morton Salt in 1939, Crawford Manufacturing in 1956, and Pioneer Container in 1984 - has held that application of the unitary business principle is appropriate under Kansas law.

When the unitary business principle is applied to more than one company, a combined report is required for all companies that comprise the unitary enterprise. The combined net income (excluding intra-group transactions to avoid double counting) is apportioned among the states in which all or any members of the unitary group are doing business.

The unitary business principle and combined reporting are used when the relationships between companies are so interwoven that income cannot reasonably be attributed to a particular company or state. Combined reporting prevents firms from manipulating income between related entities and thus prevents the under reporting of income generated from business activities in Kansas. Without the ability to require a combined report, additional state auditors would need to be retained to examine transactions between related companies to determine that such transactions are in fact "arms length" and to reallocate income and expenses between companies.

For example, combined reporting would be utilized in a situation where a holding company domiciled in Kansas operates as a financing and cost center for a group of subsidiaries. Absent a combined report, the holding company would report operating losses to Kansas while the profits generated from the expenditures would be reported in the subsidiaries operating in other states. If none of the profitable subsidiaries do business in Kansas, the commercial domicile of the holding company, the state would be able to tax only the loss corporation and not be able to tax the income to which the activities of the holding company materially contributed. The combined report alters this result by allowing Kansas to tax the income which is attributable to the business activities of the holding company within the state which activities generate income for the unitary group of companies.

Under the Department's current policy, two corporations will be treated as unitary if there is functional integration between them. This assures that unitary assessments are based upon meaningful and substantial interrelationships between the combined companies. The Department believes that functional integration provides a more reasonable, definite and predictable basis for combination.

Fifteen states require that unitary companies file combined reports. Another four states make the filing of a combined report optional.